

ATHENAHEALTH INC  
Form 10-Q  
April 26, 2012  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**Form 10-Q**

(Mark One)

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

For the quarterly period ended March 31, 2012

or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 001-33689

**athenahealth, Inc.**

(Exact name of registrant as specified in its charter)

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**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**04-3387530**  
(I.R.S. Employer  
Identification No.)

**311 Arsenal Street, Watertown,**

**Massachusetts**  
(Address of principal executive offices)

**02472**  
(Zip Code)

**617-402-1000**

(Registrant's telephone number, including area code)

(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  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  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 the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company) 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

As of April 23, 2012, there were 35,844,779 shares of the registrant's \$0.01 par value common stock outstanding.

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**athenahealth, Inc.**

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|  | March<br>31, 2012 | December<br>31, 2011 |
|--|-------------------|----------------------|
| <b>Assets</b>  |                   |                      |
| Current assets:  |                   |                      |
| Cash and cash equivalents  | \$ 52,491         | \$ 57,781            |
| Short-term investments   | 63,550            | 62,084               |
| Current portion of restricted cash   | 4,047             |                      |
| Accounts receivable - net  | 53,058            | 49,038               |
| Deferred tax assets  | 5,527             | 5,245                |
| Prepaid expenses and other current assets  | 12,549            | 8,988                |
| <b>Total current assets</b>  | <b>191,222</b>    | <b>183,136</b>       |
| Property and equipment - net   | 51,482            | 52,275               |
| Restricted cash, net of current portion  | 856               | 5,007                |
| Software development costs - net   | 8,187             | 6,974                |
| Purchased intangibles - net  | 19,299            | 20,052               |
| Goodwill   | 47,307            | 47,307               |
| Deferred tax assets  | 12,191            | 12,532               |
| Investments and other assets   | 20,360            | 21,503               |
| <b>Total assets</b>  | <b>\$ 350,904</b> | <b>\$ 348,786</b>    |
| <b>Liabilities &amp; Stockholders' Equity</b>  |                   |                      |
| Current liabilities:   |                   |                      |
| Accounts payable   | \$ 4,556          | \$ 6,318             |
| Accrued compensation   | 16,829            | 28,176               |
| Accrued expenses   | 17,753            | 17,774               |
| Current portion of deferred revenue  | 6,311             | 6,345                |
| Current portion of deferred rent   | 987               | 960                  |
| <b>Total current liabilities</b>   | <b>46,436</b>     | <b>59,573</b>        |
| Deferred rent, net of current portion  | 2,684             | 2,932                |
| Deferred revenue, net of current portion   | 45,173            | 44,281               |
| Other long-term liabilities  | 3,109             | 5,529                |
| <b>Total liabilities</b>   | <b>97,402</b>     | <b>112,315</b>       |
| Commitments and contingencies (note 5)   |                   |                      |
| Stockholders' equity:  |                   |                      |
| Preferred stock, \$0.01 par value: 5,000 shares authorized; no shares issued and outstanding at March 31, 2012 and December 31, 2011, respectively |                   |                      |

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|  |            |            |
|--|------------|------------|
| Common stock, \$0.01 par value: 125,000 shares authorized; 37,024 shares issued, and 35,746 shares outstanding at March 31, 2012; 36,678 shares issued and 35,400 shares outstanding at December 31, 2011. | 370        | 367        |
| Additional paid-in capital   | 261,668    | 247,131    |
| Treasury stock, at cost, 1,278 shares  | (1,200)    | (1,200)    |
| Accumulated other comprehensive loss   | (38)       | (101)      |
| Accumulated deficit  | (7,298)    | (9,726)    |
| Total stockholders' equity   | 253,502    | 236,471    |
| Total liabilities and stockholders' equity   | \$ 350,904 | \$ 348,786 |

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

**Table of Contents****athenahealth, Inc.****CONDENSED CONSOLIDATED STATEMENTS OF INCOME****(Unaudited, in thousands, except per-share amounts)**

|   | March 31,       |                 |
|---|-----------------|-----------------|
|   | 2012            | 2011            |
| <b>Revenue:</b>   |                 |                 |
| Business services   | \$ 93,549       | \$ 67,486       |
| Implementation and other  | 3,017           | 2,444           |
| <b>Total revenue</b>  | <b>96,566</b>   | <b>69,930</b>   |
| <b>Expense:</b>   |                 |                 |
| Direct operating  | 38,798          | 27,270          |
| Selling and marketing   | 23,728          | 16,941          |
| Research and development  | 7,168           | 5,079           |
| General and administrative                                      | 16,199          | 11,719          |
| Depreciation and amortization                                   | 5,486           | 3,398           |
| <b>Total expense</b>  | <b>91,379</b>   | <b>64,407</b>   |
| Operating income  | 5,187           | 5,523           |
| Other income (expense)  | 134             | 33              |
| Income before income taxes                                      | 5,321           | 5,556           |
| Income tax provision  | (2,893)         | (2,305)         |
| <b>Net income</b>   | <b>\$ 2,428</b> | <b>\$ 3,251</b> |
| Net income per share Basic                                      | \$ 0.07         | \$ 0.09         |
| Net income per share Diluted                                    | \$ 0.07         | \$ 0.09         |
| Weighted average shares used in computing net income per share: |                 |                 |
| Basic   | 35,535          | 34,678          |
| Diluted   | 36,996          | 35,657          |

**athenahealth, Inc.****CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME****(Unaudited, in thousands, except per-share amounts)**

|  | Three Months Ended<br>March 31, |           |
|--|---------------------------------|-----------|
|  | 2012                            | 2011      |
| Net income                                       | \$ 2,428                        | \$ 3,251  |
| Other comprehensive income                       |                                 |           |
| Unrealized gain (loss) on securities, net of tax | 72                              | (10)      |
| Foreign currency translation adjustment          | (9)                             | 32        |
| <b>Total other comprehensive income</b>          | <b>63</b>                       | <b>22</b> |

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|                      |          |          |
|----------------------|----------|----------|
| Comprehensive income | \$ 2,491 | \$ 3,273 |
|----------------------|----------|----------|

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

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|   | Three Months Ended<br>March 31, |          |
|---|---------------------------------|----------|
|   | 2012                            | 2011     |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                      |                                 |          |
| Net income  | \$ 2,428                        | \$ 3,251 |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                 |          |
| Depreciation and amortization   | 6,276                           | 3,858    |
| Amortization of premium on investments  | 354                             | 381      |
| Provision for uncollectible accounts  | 287                             | 259      |
| Excess tax benefit from stock-based awards  | (2,829)                         | (2,175)  |
| Deferred income tax   | 40                              | 136      |
| Increase in fair value of contingent consideration                                | 71                              | 114      |
| Stock-based compensation expense  | 5,633                           | 4,005    |
| Loss on interest rate derivative contract   |                                 | (65)     |
| Changes in operating assets and liabilities:                                      |                                 |          |
| Accounts receivable   | (4,307)                         | (6,103)  |
| Prepaid expenses and other current assets   | (847)                           | 542      |
| Other long-term assets  | 94                              | 79       |
| Accounts payable  | 3,054                           | 2,124    |
| Accrued expenses  | 77                              | 1,791    |
| Accrued compensation  | (11,347)                        | (6,593)  |
| Deferred revenue  | 858                             | 2,731    |
| Deferred rent   | (221)                           | (352)    |
| Net cash (used in) provided by operating activities                               | (379)                           | 3,983    |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                      |                                 |          |
| Capitalized software development costs  | (2,839)                         | (1,469)  |
| Purchases of property and equipment   | (10,383)                        | (2,067)  |
| Proceeds from sales and maturities of investments                                 | 25,224                          | 54,054   |
| Purchases of short-term and long-term investments                                 | (25,904)                        | (48,766) |
| Decrease in restricted cash   | 104                             | 2,887    |
| Net cash (used in) provided by investing activities                               | (13,798)                        | 4,639    |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                      |                                 |          |
| Proceeds from issuance of common stock under stock plans                          | 7,958                           | 2,125    |
| Taxes paid related to net share settlement of restricted stock awards             | (1,825)                         |          |
| Excess tax benefit from stock-based awards  | 2,829                           | 2,175    |
| Payment of contingent consideration accrued at acquisition date                   | (104)                           | (2,558)  |
| Payments on long-term debt and capital lease obligations                          |                                 | (793)    |
| Net cash provided by financing activities   | 8,858                           | 949      |
| Effects of exchange rate changes on cash and cash equivalents                     | 29                              | 67       |
| Net decrease in cash and cash equivalents   | (5,290)                         | 9,638    |
| Cash and cash equivalents at beginning of period                                  | 57,781                          | 35,944   |

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|  |           |           |
|--|-----------|-----------|
| Cash and cash equivalents at end of period                               | \$ 52,491 | \$ 45,582 |
| Non-cash transactions  |           |           |
| Property and equipment recorded in accounts payable and accrued expenses | \$ 784    | \$ 179    |
| Tax benefit recorded in prepaid expenses and other current assets        | \$ 2,774  | \$ 2,120  |
| Additional disclosures   |           |           |
| Cash paid for interest   | \$        | \$ 177    |
| Cash paid for taxes  | \$ 733    | \$ 241    |

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

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athenahealth, Inc.

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited amounts in thousands, except per-share amounts)

**1. BASIS OF PRESENTATION**

The accompanying unaudited condensed consolidated financial statements have been prepared by athenahealth, Inc. (the Company or we ) in accordance with accounting principles generally accepted in the United States ( GAAP ) for interim financial reporting and as required by Regulation S-X, Rule 10-01. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of the Company s management, the accompanying unaudited condensed consolidated financial statements contain all adjustments (consisting of items of a normal and recurring nature) necessary to present fairly the financial position as of March 31, 2012, and the results of operations and cash flows for the three month periods ended March 31, 2012 and 2011. The results of operations for the three month period ended March 31, 2012 is not necessarily indicative of the results to be expected for the full year. When preparing financial statements in conformity with GAAP, we must make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of, revenue and expenses during the reporting period. Actual results could differ from those estimates.

The Company considers events or transactions that occur after the balance sheet date but before the financial statements are issued to provide additional evidence relative to certain estimates or to identify matters that require additional disclosure. Subsequent events have been evaluated through the date of issuance of these financial statements. The accompanying unaudited condensed consolidated financial statements and notes thereto should be read in conjunction with the audited consolidated financial statements for the year ended December 31, 2011, included in our Annual Report on Form 10-K, which was filed with the Securities and Exchange Commission ( SEC ) on February 16, 2012.

**Comprehensive Income:** In June 2011, the Financial Accounting Standards Board (the FASB ) issued Standards Update 2011-5, Comprehensive Income (Topic 220) as amended, requiring amendments to disclosure for presentation of comprehensive income. This guidance, effective retrospectively for the interim and annual periods beginning on or after December 31, 2011, requires presentation of total comprehensive income, the components of net income and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In December 2011, the FASB issued an amendment to this guidance which indefinitely defers the requirement to present reclassification adjustments out of accumulated other comprehensive income by component in both the statement in which net income is presented and the statement in which other comprehensive income is presented. This guidance is effective for annual periods beginning after December 15, 2011. The Company adopted the amended guidance requiring presentation of comprehensive financial statements for the three months ended March 31, 2012. Simultaneously, the Company made the decision to change the title of their income statement from Condensed Consolidated Statement of Operations to Condensed Consolidated Statement of Income to be consistent with the new presentation. The implementation of this guidance did not have a material impact on the Company s consolidated results of operations or financial position.

Comprehensive income is defined as net income or loss and other changes in stockholders equity from transactions and other events from sources other than stockholders. Comprehensive income is reflected in the Consolidated Statements of Comprehensive Income.

**2. NET INCOME PER SHARE**

Basic net income per share is computed by dividing net income by the weighted average number of common shares outstanding during the period. Diluted net income per share is computed by dividing net income by the weighted average number of common shares outstanding and potentially dilutive securities outstanding during the period under the treasury stock method. Potentially dilutive securities include stock options, restricted stock units, shares to be purchased under the employee stock purchase plan, and warrants. Under the treasury stock method, dilutive securities are assumed to be exercised at the beginning of the periods and as if funds obtained thereby were used to purchase common stock at the average market price during the period. Securities are excluded from the computations of diluted net income per share if their effect would be antidilutive to earnings per share.

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The following table reconciles the weighted average shares outstanding for basic and diluted net income per share for the periods indicated:

|  | Three Months Ended<br>March 31, 2012 | Three Months Ended<br>March 31, 2011 |
|--|--------------------------------------|--------------------------------------|
| Net income   | \$ 2,428                             | \$ 3,251                             |
| Weighted average shares used in computing basic net income per share   | 35,535                               | 34,678                               |
| Net income per share basic   | \$ 0.07                              | \$ 0.09                              |
| Net income   | \$ 2,428                             | \$ 3,251                             |
| Weighted average shares used in computing basic net income per share   | 35,535                               | 34,678                               |
| Effect of dilutive securities  | 1,461                                | 979                                  |
| Weighted average shares used in computing diluted net income per share | 36,996                               | 35,657                               |
| Net income per share diluted   | \$ 0.07                              | \$ 0.09                              |

The computation of diluted net income per share does not include 0.4 million options and restricted stock units for the three months ended March 31, 2012, because their inclusion would have an antidilutive effect on net income per share. The computation of diluted net income per share does not include 0.9 million options and restricted stock units for the three months ended March 31, 2011, because their inclusion would have an antidilutive effect on net income per share.

**3. FAIR VALUE OF FINANCIAL INSTRUMENTS**

The following table presents information about the Company's financial assets and liabilities that are measured at fair value on a recurring basis as of March 31, 2012 and December 31, 2011, and indicates the fair value hierarchy of the valuation techniques the Company utilized to determine such fair value. In general, fair values determined by Level 1 inputs utilize quoted prices (unadjusted) in active markets for identical assets or liabilities and fair values determined by Level 2 inputs utilize quoted prices (unadjusted) in inactive markets for identical assets or liabilities obtained from readily available pricing sources for similar instruments. The fair values determined by Level 3 inputs are unobservable values which are supported by little or no market activity. Investments include \$16.0 million of long-term U.S. government backed securities and \$1.6 million of long-term corporate bonds for a total of \$17.6 million in long-term investments that have been classified in investments and other assets on the Condensed Consolidated Balance Sheet at March 31, 2012. Investments include \$18.6 million of long-term U.S. government backed securities that have been classified in investments and other assets on the Condensed Consolidated Balance Sheet at December 31, 2011.

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|  | Fair Value Measurements At March 31, 2012, Using |                  |                   | Total             |
|--|--|------------------|-------------------|-------------------|
|  | Level 1  | Level 2          | Level 3           |                   |
| <b>Cash and cash equivalents:</b>      |  |                  |                   |                   |
| Money market                           | \$ 31,130  | \$               | \$                | \$ 31,130         |
| Commercial paper                       |  | 4,900            | \$                | 4,900             |
| <b>Available-for-sale investments:</b> |  |                  |                   |                   |
| Commercial paper                       |  | 15,743           |                   | 15,743            |
| Corporate bonds                        |  | 43,485           |                   | 43,485            |
| Certificate of Deposit                 |  | 4,010            |                   | 4,010             |
| U.S. government backed securities      |  | 17,882           |                   | 17,882            |
| <b>Total assets</b>                    | <b>\$ 31,130</b>                                 | <b>\$ 86,020</b> | <b>\$</b>         | <b>\$ 117,150</b> |
| Accrued contingent consideration       | \$   | \$               | \$ (8,143)        | \$ (8,143)        |
| <b>Total liabilities</b>               | <b>\$</b>  | <b>\$</b>        | <b>\$ (8,143)</b> | <b>\$ (8,143)</b> |

|  | Fair Value Measurements as of December 31, 2011, |                  |                   | Total             |
|--|--|------------------|-------------------|-------------------|
|  | Level 1  | Using<br>Level 2 | Level 3           |                   |
| <b>Cash and cash equivalents:</b>      |  |                  |                   |                   |
| Money market                           | \$ 33,444  | \$               | \$                | \$ 33,444         |
| Corporate bonds                        |  | 7,250            |                   | 7,250             |
| <b>Available-for-sale investments:</b> |  |                  |                   |                   |
| Commercial paper                       |  | 6,499            |                   | 6,499             |
| Corporate bonds                        |  | 40,833           |                   | 40,833            |
| U.S. government backed securities      |  | 33,370           |                   | 33,370            |
| <b>Total assets</b>                    | <b>\$ 33,444</b>                                 | <b>\$ 87,952</b> | <b>\$</b>         | <b>\$ 121,396</b> |
| Accrued contingent consideration       | \$   | \$               | \$ (8,176)        | \$ (8,176)        |
| <b>Total liabilities</b>               | <b>\$</b>  | <b>\$</b>        | <b>\$ (8,176)</b> | <b>\$ (8,176)</b> |

Money markets, certificates of deposit, U.S. government backed securities, corporate bonds and commercial paper are valued using a market approach based upon the quoted market prices of identical instruments when available or other observable inputs such as trading prices of identical instruments in inactive markets or similar securities. It is the Company's policy to recognize transfers between levels of the fair value hierarchy, if any, at the end of the reporting period however there have been no such transfers during any periods presented.

Contingent consideration is recorded at fair value as an element of consideration paid with subsequent adjustments recognized in the Condensed Consolidated Statement of Income. At the acquisition date and reporting date, the fair value of the accrued contingent consideration was determined using a probability-weighted income approach based on upside, downside and base case scenarios. This approach is based on significant inputs that are not observable in the market, which are referred to as Level 3 inputs. As of March 31, 2012, and December 31, 2011, the Company has accrued a liability of \$8.1 million and \$8.2 million, respectively for the estimated fair value of contingent considerations estimated to be payable upon the acquired companies reaching specific performance metrics over a specified period of operations after acquisition. The elements that make up the contingent consideration are as follows:

**Anodyne**

The first potential contingent consideration related to our acquisition of Anodyne Health Partners, Inc. ( Anodyne ) in 2009 ranges from zero to \$4.8 million and is payable in one installment based upon operational performance for the year ended December 31, 2010. Based on the actual operational performance for the year ended December 31, 2010, the Company had accrued \$2.4 million relating to the first potential contingent consideration which was paid in March of 2011.

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The second potential contingent consideration related to our acquisition of Anodyne in 2009 ranges from zero to \$2.9 million and is payable in quarterly installments based upon the cross selling of the Company's services for the years ended December 31, 2010 and 2011, and the six-month period ending June 30, 2012. Any amounts not earned in the first potential contingent consideration can be earned under the second potential contingent consideration in excess of the initial \$2.9 million bringing the total potential contingent consideration to \$5.3 million. On December 31, 2011, the Company valued the second contingent consideration at \$1.4 million based on key assumptions including a probability adjusted level of 50% for the base case scenario and 25% for the upside and downside scenarios. The significant judgment related to the estimated earn-out payments by scenario was primarily based on the Company's i) past experience of our cross selling, ii) past experience of the timeline for converting pipeline opportunities into customers and iii)

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the remaining time period of this contingent consideration. At December 31, 2011, a large cross sell customer opportunity was included in the upside scenario which had a 25% probability. On March 31, 2012, the Company valued the second contingent consideration at \$3.4 million based on key assumptions including a 20% for the base case scenario, 70% for the upside scenario and 10% for the downside scenario. At March 31, 2012, this large cross sell opportunity was in final contract negotiations with the Company and therefore a higher probability was assigned to the upside scenario. The change in fair value of \$2.2 million is an increase in the general and administrative line item in the Condensed Consolidated Statement of Income for the three months ended March 31, 2012. The Company paid \$0.1 million and \$0.2 million during the three months ended March 31, 2012 and 2011, respectively, under the terms of the second potential contingent consideration and has paid \$1.3 million over the term of the contingent consideration to date.

**Proxsys**

The first potential contingent consideration related to our acquisition of Proxsys LLC ( Proxsys ) in 2011 ranges from zero to \$3.0 million and is payable in one installment in the first quarter of 2013 based upon revenue and new sales performance for the fiscal year ending December 31, 2012. In order to qualify for the earnout payment, the acquired subsidiary must achieve a minimum revenue threshold which was derived from both recurring revenue and revenue generated from new customers brought onto the service after the acquisition. Once that minimum revenue threshold is met, the amount of the payment is then determined by new sales of the Company's athenaCoordinator service offering since date of acquisition. On December 31, 2011, the Company valued the first potential contingent consideration at \$2.4 million, the key assumptions relating to this potential contingent consideration included the athenaCoordinator revenue budget for the 2012 fiscal year, which included recurring revenue and estimates related to the new revenue generated from new customers based upon the existing sales pipeline and historical implementation timeline and a probability adjusted level of 60% for the base case and 25% and 15% for the upside and downside scenarios, respectively. The athenaCoordinator revenue budget for the 2012 fiscal year exceeded the minimum revenue threshold. The downside scenarios included a worse case scenario where the acquired subsidiary did not achieve the minimum revenue target. Certain contracts that were in an advanced negotiation stage at December 31, 2011 and estimated to close in the first quarter of 2012, did not close during the three months ended March 31, 2012; therefore as of March 31, 2012, the Company determined that it is more likely than not that athenaCoordinator will miss the minimum revenue threshold by 5-10%. On March 31, 2012, the Company has determined that based on the reforecasted amounts and the pass fail structure of this contingent payment, the probability percentages have been adjusted to 90% for the worse case scenario and 10% for the upside scenario. On March 31, 2012 the Company valued the first potential contingent consideration at \$0.3 million and therefore a change in fair value of \$2.1 million is a decrease in the general and administrative expense line item in the Condensed Consolidated Statement of Income for the three months ended March 31, 2012.

The second potential contingent consideration related to our acquisition of Proxsys in 2011 ranges from zero to \$5.0 million and is payable in quarterly installments based upon the cross selling of the Company's services into the new and acquired company's customer base from acquisition to the second year anniversary of the acquisition in the third quarter of 2013. On March 31, 2012 and December 31, 2011, the key assumptions relating to this potential contingent consideration included a probability adjusted level of 65% for the base case and 25% and 10% for the upside and downside scenarios, respectively. The Company valued the contingent consideration at March 31, 2012 at \$4.4 million.

The reconciliations for the fair values of financial instruments determined by Level 3 for the years presented, are as follows:

|   | Three Months<br>Ended March<br>31, 2012 | Three Months<br>Ended March<br>31, 2011 |
|---|---|---|
| Balance beginning of period                     | \$ 8,176                                | \$ 4,655                                |
| Payments  | (104)                                   | (2,558)                                 |
| Change in fair value (included in G&A expenses) | 71                                      | 114                                     |
| Balance end of period                           | \$ 8,143                                | \$ 2,211                                |

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The summary of available-for-sale securities at March 31, 2012, is as follows:

|                                   | Amortized Cost   | Gross Unrealized<br>Gain (Loss) | Fair Value       |
|-----------------------------------|------------------|---------------------------------|------------------|
| Commercial paper                  | \$ 20,623        | \$ 20                           | \$ 20,643        |
| Corporate bonds                   | 43,456           | 28                              | 43,484           |
| Certificate of Deposit            | 4,000            | 10                              | 4,010            |
| U.S. government backed securities | 17,873           | 9                               | 17,882           |
| <b>Total</b>                      | <b>\$ 85,952</b> | <b>\$ 67</b>                    | <b>\$ 86,019</b> |

The summary of available-for-sale securities at December 31, 2011, is as follows:

|                                   | Amortized Cost   | Gross Unrealized<br>Gains | Fair Value       |
|-----------------------------------|------------------|---------------------------|------------------|
| Commercial paper                  | \$ 13,739        | \$ 10                     | \$ 13,749        |
| Corporate bonds                   | 40,863           | (30)                      | 40,833           |
| U.S. government backed securities | 33,374           | (4)                       | 33,370           |
| <b>Total</b>                      | <b>\$ 87,976</b> | <b>\$ (24)</b>            | <b>\$ 87,952</b> |

**5. COMMITMENTS AND CONTINGENCIES*****Prompt Medical Systems, L.P.***

On March 2, 2010, a complaint was filed by Prompt Medical Systems, L.P. naming the Company and several other defendants in a patent infringement case (*Prompt Medical Systems, L.P. v. AllscriptsMisys Healthcare Solutions, Inc. et al.*, Civil Action No. 6:2010cv00071, United States District Court for the Eastern District of Texas). The complaint alleges that the Company has infringed U.S. Patent No. 5,483,443 with a listed issue date of January 9, 1996, entitled Method for Computing Current Procedural Terminology Codes from Physician Generated Documentation. The complaint seeks an injunction enjoining infringement, damages, and pre- and post-judgment costs and interest. In March 2012, the plaintiff, the Company, and two other defendants entered into a confidential settlement agreement which provided for, among other things, a complete and final settlement of all claims between the parties for certain releases, covenants not to sue, and a license with respect to the claims of the patent to sell and provide the Company's services. The Company was indemnified in this lawsuit from and against any liability, pursuant to a license agreement with one of its vendors. On March 27, 2012, the Court dismissed all claims and counterclaims between the Company and the other parties to the settlement agreement.

***PPS Data, LLC***

On July 28, 2011, a complaint was filed by PPS Data, LLC naming the Company in a patent infringement case (*PPS Data, LLC v. athenahealth, Inc.*, Civil Action No. 3:11-cv-00746, United States District Court for the Middle District of Florida). The complaint alleges that the Company has infringed U.S. Patent No. 6,343,271 with a listed issue date of January 29, 2002, entitled Electronic Creation, Submission, Adjudication, and Payment of Health Insurance Claims (the 271 Patent). The complaint seeks an injunction enjoining infringement, damages, pre- and post-judgment costs and interest, and attorneys' fees. On September 8, 2011, the Company filed a motion to dismiss, or, in the alternative, a motion for summary judgment. On October 18, 2011, the plaintiff filed a motion for leave to amend its complaint to allege that the Company has infringed on U.S. Patent No. 6,341,265 with a listed issue date of January 22, 2002, entitled Provider claim editing and settlement system, and U.S. Patent No. 7,194,416 with a listed issue date of March 20, 2007, entitled Interactive creation and adjudication of health care insurance claims. The Court granted the plaintiff's motion for leave to amend its complaint on December 21, 2011, and on December 23, 2011, the plaintiff filed its amended complaint. On December 27, 2011, the Company filed a motion to dismiss, or, in the alternative, a motion for summary judgment of non-infringement with respect to the 271 Patent. On December 29, 2011, the United States Patent and Trademark Office granted the Company's request for reexamination of the 271 Patent. On January 9, 2012, the Company filed a motion to stay the case pending completion of

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the patent reexamination, and on March 1, 2012, the Court granted the Company's motion to stay the case. The Company believes that it has meritorious defenses to the amended complaint and will continue to contest the claims vigorously.

**Table of Contents*****Medsquire, LLC***

On December 6, 2011, a complaint was filed by Medsquire, LLC against the Company in a patent infringement case (*Medsquire, LLC v. athenahealth, Inc.*, Civil Action No. 2:11-CV-10126-JHN-PLA, United States District Court for the Central District of California). The complaint alleges that the Company has infringed U.S. Patent No. 5,682,526 with a listed issue date of October 28, 1997, entitled Method and System for Flexibly Organizing, Recording, and Displaying Medical Patient Care Information Using Fields in a Flowsheet. The complaint seeks damages, pre-judgment interest, and attorneys' fees. The Company believes that it has meritorious defenses to the complaint and will contest the claims vigorously.

***AdvancedMD Software, Inc.***

On July 18, 2011, the Company filed a complaint against AdvancedMD Software, Inc. in the United States District Court for the District of Massachusetts. The complaint alleges that AdvancedMD Software, Inc. has infringed two of the Company's U.S. Patents: No. 7,617,116, which was issued on November 10, 2009, for Practice Management and Billing Automation System and No. 7,720,701, which was issued on May 18, 2010, for Automated Configuration of Medical Practice Management Systems. The Company is seeking permanent injunctive relief, damages, pre- and post-judgment costs and interest, and attorneys' fees.

***Cordjia, LLC***

On July 18, 2011, a complaint was filed in the Superior Court for Waldo County, Maine, against the Company entitled *Cordjia, LLC v. athenahealth, Inc.* The complaint alleges that the Company entered into a partnership with the plaintiff to purchase property in Maine, that the parties entered into a mutual non-disclosure agreement governing the sharing of confidential information between them, and that the Company subsequently terminated the partnership and purchased the property itself, using the confidential information obtained from the plaintiff to do so. The complaint purports to state claims for common-law fraud, negligent misrepresentation, breach of fiduciary duty, unjust enrichment, *quantum meruit*, promissory estoppel, breach of contract, and violation of the Maine Uniform Trade Secrets Act. The complaint seeks unspecified damages, fees and costs, and injunctive relief enjoining the Company from making further use of the plaintiff's confidential information and requiring the Company to return all confidential information in its possession to the plaintiff. On August 8, 2011, the Company filed a motion to dismiss for improper venue. On November 17, 2011, the Court granted the Company's motion to dismiss for improper venue as to the claims for unjust enrichment, *quantum meruit*, breach of contract, and violation of the Maine Uniform Trade Secret Act, and denied the Company's motion as to the other claims. On December 7, 2011, the plaintiff filed an amended complaint, and on December 19, 2011, the Company filed a motion to dismiss the remaining claims, or in the alternative, to stay the proceeding. On March 22, 2012, the Court granted the Company's motion to stay the Maine proceedings pending the Delaware case noted below.

On December 7, 2011, a complaint was filed in the Superior Court for New Castle County, Delaware, against the Company entitled *Cordjia, LLC v. athenahealth, Inc.* The complaint pertains to the same facts as stated above and alleges claims for breach of contract, unjust enrichment, *quantum meruit*, and violation of the Delaware Uniform Trade Secrets Act. The complaint seeks unspecified damages, fees and costs, an injunction enjoining the Company from making any further use of the confidential information, and an order requiring the Company to return any copies of confidential information. On February 2, 2012, the Company filed a motion to dismiss the complaint. On March 30, 2012, the Court held oral argument on the Company's motion to dismiss.

The Company believes that it has meritorious defenses to the complaints and intends to contest the claims vigorously.

***Kickapoo Run, LLC***

On September 16, 2011, a complaint was filed by Kickapoo Run, LLC naming the Company and several other defendants in a patent infringement case (*Kickapoo Run, LLC v. athenahealth, Inc. et al.*, Civil Action No. 1:99-mc-09999, United States District Court for the District of Delaware). The complaint alleges that the Company has infringed U.S. Patent No. 5,961,332 with a listed issue date of October 5, 1999, entitled Apparatus for Processing Psychological Data and Method of Use Thereof. The complaint seeks an injunction enjoining infringement, damages, costs, expenses, pre- and post-judgment interest, and attorneys' fees. The Company believes that it has meritorious defenses to the complaint and will contest the claims vigorously.

In addition, from time to time the Company may be subject to other legal proceedings, claims, and litigation arising in the ordinary course of business. The Company does not, however, currently expect that the ultimate costs to resolve any pending matter will have a material effect on the Company's consolidated financial position, results of operations, or cash flows.



**Table of Contents****Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.**

*This Quarterly Report on Form 10-Q contains forward-looking statements. All statements other than statements of historical fact contained in this Quarterly Report on Form 10-Q are forward-looking statements, including those regarding expanded sales and marketing efforts; changes in expenses related to operations, selling, marketing, research and development, general and administrative matters, and depreciation and amortization; liquidity issues; additional fundraising; and the expected performance period and estimated term of our client relationships, as well as more general statements regarding our expectations for future financial and operational performance, product and service offerings, regulatory environment, and market trends. In some cases, you can identify forward-looking statements by terminology such as may, will, should, expects, plans, anticipates, believes, estimates, predicts, potential, or continue ; the negative of these terms; or other comparable terminology. Forward-looking statements in this Item 2 include, without limitation, statements reflecting management's expectations for future financial performance and operating expenditures, expected growth, profitability and business outlook, increased sales and marketing expenses, increased cross-selling efforts among the Company's service offerings, expected client implementations, expected certification and regulatory approvals and the benefits of the Company's current service offerings and research and development for new service offerings and the benefits of current and expected strategic and sales and marketing relationships.*

*Forward-looking statements are only current predictions and are subject to known and unknown risks, uncertainties, and other factors that may cause our actual results, levels of activity, performance, or achievements to be materially different from those anticipated by such statements. These factors include, among other things, those set forth in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011, under the heading Part I, Item 1A Risk Factors and any set forth below under Part II, Item 1A, Risk Factors.*

*Although we believe that the expectations reflected in the forward-looking statements contained in this Quarterly Report on Form 10-Q are reasonable, we cannot guarantee future results, levels of activity, performance, or achievements. Except as required by law, we are under no duty to update or revise any of such forward-looking statements, whether as a result of new information, future events, or otherwise, after the date of this Quarterly Report on Form 10-Q.*

**Overview**

athenahealth provides business services that help medical caregivers achieve and sustain financial health by collecting more money and exercising more control over their administrative tasks. These services are designed to reduce the administrative burden of complex billing rules, quality measurement and reporting, clinical documentation and data exchange, patient communication, and many of the related tasks that distract medical providers and staff from the practice of medicine. Our services are delivered and consumed through a single instance of our cloud-based platform, athenaNet. We differentiate our services by regularly deploying updates and improvements through athenaNet to clients without any action on the part of the client. athenaNet enables us to quickly implement our solution at a low up-front cost and to seamlessly work in tandem with our clients in real time.

The services provided through our single-instance cloud are currently packaged as four integrated components: athenaCollector for revenue cycle management, athenaClinicals for electronic health record management, athenaCommunicator for patient communication management, and athenaCoordinator for referral cycle management. The use of our single-instance platform allows all clients to benefit from the collective knowledge of all of our other clients through our patented billing Rules Engine and our clinical Quality Management Engine. Our clients use these rules engines to monitor and benchmark their performance with peer practices across the network. Our business intelligence application, Anodyne Analytics, also supports our clients in their pursuit of financial health by equipping users with data visualization tools and insight into their practice's performance.

Each service we provide is supported by a model comprised of three distinct components: Software, Knowledge, and Work. The cloud-based software is provided at no extra charge to users but is the primary conduit through which we exchange information between clients, payers, and our staff of experts. Knowledge is infused into each of our services via our Rules Engine as we work with clients, payers, and other partners to codify rules associated with reimbursement, clinical quality measures, and other factors related to our clients' performance. The third component to each of our services is the Work that we perform on behalf of our clients. Wherever possible, we replace manual processes with automation, but where automation is not possible, we provide that manual labor rather than returning it to clients to be completed. This unique service model of Software, Knowledge, and Work has allowed us to align our success with our clients' performance, creating a continual cycle of improvement and efficiency. We charge clients a percentage of collections in most cases, so our financial results are a direct reflection of our ability to drive revenue to medical practices.

For the three months ended March 31, 2012, we generated revenue of \$96.6 million from the sale of our services compared to \$69.9 million for the three months ended March 31, 2011. Given the scope of our market opportunity, we have increased our spending each year on growth, innovation, and infrastructure. Despite increased spending in these areas, higher revenue and lower operating expenses as a percentage of revenue typically lead to greater operating income.

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Our revenue is predominately derived from business services that we provide on an ongoing basis. This revenue is generally determined as a percentage of payments collected by us on behalf of our clients, so the key drivers of our revenue include growth in the number of physicians working within our client accounts, the collections of these physicians, and the number of services

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purchased. To provide these services, we incur expenses in several categories, including direct operating, selling and marketing, research and development, general and administrative, and depreciation and amortization expense. In general, our direct operating expense increases as our volume of work increases, whereas our selling and marketing expense increases in proportion to our intended growth rate of adding new accounts to our network of physician clients. Our other expense categories are less directly related to growth of revenues and relate more to our planning for the future, our overall business management activities, and our infrastructure. We manage our cash and our use of credit facilities to ensure adequate liquidity, in adherence to related financial covenants.

### **Critical Accounting Policies**

The preparation of our consolidated financial statements in conformity with GAAP requires us to make estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities and the disclosures of contingent assets and liabilities as of the date of the financial statements, and the reported amounts of revenues and expenses during the reporting periods. Significant estimates and assumptions are used for, but are not limited to: (1) revenue recognition; including our estimated expected customer life; (2) asset impairments; (3) depreciable lives of assets; (4) fair value of stock options; (5) allocation of direct and indirect cost of sales; (6) fair value of contingent consideration and acquired intangible assets; and (7) litigation reserves. Future events and their effects cannot be predicted with certainty, and accordingly, our accounting estimates require the exercise of judgment. The accounting estimates used in the preparation of our consolidated financial statements will change as new events occur, as more experience is acquired, as additional information is obtained and as our operating environment changes. We evaluate and update our assumptions and estimates on an ongoing basis and may employ outside experts to assist in our evaluations. Actual results could differ from the estimates we have used.

Critical accounting policies are those policies that affect our more significant judgments and estimates used in the preparation of our condensed consolidated financial statements. We believe our critical accounting policies include our policies regarding revenue recognition, and business combinations related to purchased intangibles and contingent consideration. For a more detailed discussion of our critical accounting policies, please refer to our Annual Report on Form 10-K for the fiscal year ended December 31, 2011, as filed with the Securities and Exchange Commission on February 16, 2012.

### **Financial Operations Overview**

*Revenue.* We derive our revenue from two sources: from business services associated with our revenue cycle management, electronic health record management, patient communication management, care coordination and analytics offerings and from implementation and other services. Implementation and other revenue consist primarily of professional services fees related to assisting clients with the initial implementation of our services and for ongoing training and related support services. Business services accounted for approximately 97% of our total revenues for the three months ended March 31, 2012 and 2011. Business services revenue are typically 2% to 8% of a practice's total collections depending upon the services purchased, the size, complexity, and other characteristics of the practice, plus a per-statement charge for billing statements that are generated for patients. Accordingly, business services revenue is largely driven by: the number of physician practices and other service providers we serve, the number of physicians and other medical providers working in those physician practices, the volume of activity and related collections of those physicians, the mix of our services used by those physician practices and other medical providers, and our contracted rates. There is moderate seasonality in the activity level of physician practices. Typically, discretionary use of physician services declines in the late summer and during the holiday season, which leads to a decline in collections by our physician clients about 30 to 50 days later. Additionally, the volume of activity and related collections vary from year to year based in large part on the severity, length and timing of the onset of the flu season. While we believe that the severity, length and timing of the onset of the cold and flu season will continue to impact collections by our physician clients, there can be no assurance that our future sales of these services will necessarily follow historical patterns. Implementation and other revenue are largely driven by the increase in the volume of our new business. As a result, we expect implementation and other revenue to increase in absolute terms for the foreseeable future but to remain relatively consistent as a percentage of total revenue. None of our clients accounted for more than 10% of our total revenues for the three months ended March 31, 2012 and 2011.

*Direct Operating Expense.* Direct operating expense consists primarily of salaries, benefits, claim processing costs, other direct expenses, and stock-based compensation related to personnel who provide services to clients, including staff who implement new clients. We expense implementation costs as incurred. We include in direct operating expense all service costs associated with athenaCollector, athenaClinicals, athenaCommunicator, athenaCoordinator and Anodyne Analytics. Although we expect that direct operating expense will increase in absolute terms for the foreseeable future, the direct operating expense is expected in the long-term to decline as a percentage of revenue as we increase automation. Additionally, in the near term, we expect that the percentage of direct operating expenses as a percentage of revenue will slightly increase until we fully integrate our newly acquired business and automate our new care coordinator offering. Direct operating expense does not include allocated amounts for rent, occupancy and other indirect costs (including building maintenance and utilities), depreciation, and amortization, except for amortization related to purchased intangible assets.

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*Selling and Marketing Expense.* Selling and marketing expense consists primarily of marketing programs (including trade shows, brand messaging, and on-line initiatives) and personnel-related expense for sales and marketing employees (including salaries, benefits, commissions, stock-based compensation, non-billable travel, lodging, and other out-of-pocket employee-related expenses).

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Although we recognize substantially all of our revenue when services have been delivered, we recognize a large portion of our sales commission expense at the time of contract signature and at the time our services commence. Accordingly, we incur a portion of our sales and marketing expense prior to the recognition of the corresponding revenue. We have increased our sales and marketing expenses from year to year and we expect to continue to increase our investment in sales and marketing by hiring additional direct sales personnel and support personnel to add new clients and increase sales to our existing clients and expand awareness through paid search and other similar initiatives. We also plan to expand our marketing activities, such as attending trade shows, expanding user groups, and creating new printed materials. As a result, we expect that, in the near-term, sales and marketing expense will increase in at the same rate as revenue growth.

*Research and Development Expense.* Research and development expense consists primarily of personnel-related expenses for research and development employees (including salaries, benefits, stock-based compensation, non-billable travel, lodging, and other out-of-pocket employee-related expenses) and consulting fees for third-party developers. We expect that, in the near-term, research and development expense will increase in absolute terms and will likely increase as a percentage of total revenue as we develop and enhance new and existing services.

*General and Administrative Expense.* General and administrative expense consists primarily of personnel-related expense for administrative employees (including salaries, benefits, stock-based compensation, non-billable travel, lodging, and other out-of-pocket employee-related expense), occupancy and other indirect costs (including building maintenance and utilities), and insurance premiums; software as a service fees; outside professional fees for accountants, lawyers, and consultants; and compensation for temporary employees. We expect that general and administrative expense will increase in absolute terms as we invest in infrastructure to support our growth. Though expenses are expected to continue to rise in absolute terms, we expect general and administrative expense to decline as a percentage of total revenue over time.

*Depreciation and Amortization Expense.* Depreciation and amortization expense consists primarily of depreciation of fixed assets and amortization of capitalized software development and acquisition costs, which we amortize over a two to three-year period from the time of release of related software code. As we grow, we will continue to make capital investments in the infrastructure of the business and we will continue to develop software that we capitalize. In the near term we expect depreciation and amortization expense to increase as a percentage of total revenue.

*Other Income (Expense).* Interest income represents earnings from our cash, cash equivalents, and investments. We expect that our interest expense will be insignificant until such time we determine it is appropriate to draw down on our new financing arrangements.

*Income Tax Provision.* Income tax provision consists of federal and state income taxes in the United States and India. The difference between our effective tax rate and our statutory rate is mainly related to any changes in the fair value of contingent considerations related to non-tax deductible goodwill, the treatment of Incentive Stock Options ( ISOs ) and the impact of certain tax deduction limits related to certain of our highly compensated officers. The changes in fair value of contingent consideration related to non-tax deductible goodwill and the treatment of disqualifying dispositions related to ISOs are also treated as discrete items which means they are recorded in the quarter in which they occur and could cause significant differences between the quarterly and annual effective tax rate. Also, we substantially ceased issuing ISOs in 2009, but we expect continued volatility related to these options since we cannot anticipate when disqualifying dispositions related to these options will occur.

**Results of Operations***Comparison of the Three Months Ended March 31, 2012 and 2011*

|                          | Three Months Ended March 31, |                  | Change           |            |
|--------------------------|------------------------------|------------------|------------------|------------|
|                          | 2012                         | 2011             | Amount           | Percent    |
|                          | (in thousands)               |                  |                  |            |
| Business services        | \$ 93,549                    | \$ 67,486        | \$ 26,063        | 39%        |
| Implementation and other | 3,017                        | 2,444            | 573              | 23%        |
| <b>Total</b>             | <b>\$ 96,566</b>             | <b>\$ 69,930</b> | <b>\$ 26,636</b> | <b>38%</b> |

*Revenue.* Total revenue for the three months ended March 31, 2012, was \$96.6 million, an increase of \$26.6 million, or 38%, over revenue of \$69.9 million for the three months ended March 31, 2011. This increase was due almost entirely to an increase in business services revenue.



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**Business Services Revenue.** Revenue from business services for the three months ended March 31, 2012, was \$93.5 million, an increase of 39%, over revenue of \$67.5 million for the three months ended March 31, 2011. This increase was primarily due to the growth in the number of physicians and medical providers using our services. The summary of changes in the physicians and active medical providers using our revenue cycle management service, athenaCollector, electronic health record management service, athenaClinicals, and patient communication management service, athenaCommunicator are as follows:

|  | As of March 31, |                | Change |         |
|--|-----------------|----------------|--------|---------|
|  | 2012<br>Amount  | 2011<br>Amount | Amount | Percent |
| Physicians revenue cycle management service                          | 24,101          | 19,778         | 4,323  | 22%     |
| Active medical providers revenue cycle management service            | 33,923          | 27,944         | 5,979  | 21%     |
| Physicians electronic health record management service               | 5,331           | 2,910          | 2,421  | 83%     |
| Active medical providers electronic health record management service | 7,402           | 4,161          | 3,241  | 78%     |
| Physicians patient communication management service                  | 4,820           | 934            | 3,886  | 416%    |
| Active medical providers patient communication management service    | 6,800           | 1,564          | 5,236  | 335%    |

Also contributing to this increase was the growth in related collections on behalf of these physicians and medical providers. The amount of collections processed for the three months ended March 31, 2012 was \$2.1 billion, an increase of \$0.5 billion, over posted collections of \$1.6 billion for the three months ended March 31, 2011.

**Implementation and Other Revenue.** Revenue from implementations and other sources was \$3.0 million for the three months ended March 31, 2012, an increase of \$0.6 million, or 23%, over revenue of \$2.4 million for the three months ended March 31, 2011. This increase was driven by new client implementations and increased professional services for our larger client base. The increase in implementation and other revenue is the result of the increase in the volume of our new business.

|                        | Three Months Ended March 31, |                | Change    |         |
|------------------------|------------------------------|----------------|-----------|---------|
|                        | 2012<br>Amount               | 2011<br>Amount | Amount    | Percent |
| Direct operating costs | \$ 38,798                    | \$ 27,270      | \$ 11,528 | 42%     |

(in thousands)

**Direct Operating Costs.** Direct operating expense for the three months ended March 31, 2012, was \$38.8 million, an increase of 42%, over costs of \$27.3 million for the three months ended March 31, 2011. This increase was primarily due to an increase in the number of claims that we processed on behalf of our clients and the related expense of providing services, including transactions expense and employee-related costs. The total claims submitted on behalf of clients for the three months ended March 31, 2012 was 17.8 million, an increase of 4.2 million, or 31%, over total claims submitted of 13.7 million for the three months ended March 31, 2011. Direct operating employee-related costs, including stock-based compensation, increased \$7.4 million from the three months ended March 31, 2011, to the three months ended March 31, 2012. This increase is primarily due to the 19% increase in headcount since March 31, 2011, which does not include the approximately 200 employees from our acquisition of Proxsys at the end of August 2011. Not including our acquisition of Proxsys, we increased headcount to meet the current and anticipated demand for our services as our customer base has expanded and includes larger medical groups.

|                               | Three Months Ended March 31, |                | Change    |         |
|-------------------------------|------------------------------|----------------|-----------|---------|
|                               | 2012<br>Amount               | 2011<br>Amount | Amount    | Percent |
| Selling and marketing         | \$ 23,728                    | \$ 16,941      | \$ 6,787  | 40%     |
| Research and development      | 7,168                        | 5,079          | 2,089     | 41%     |
| General and administrative    | 16,199                       | 11,719         | 4,480     | 38%     |
| Depreciation and amortization | 5,486                        | 3,398          | 2,088     | 61%     |
| Total                         | \$ 52,581                    | \$ 37,137      | \$ 15,444 | 42%     |

(in thousands)



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*Selling and Marketing Expense.* Selling and marketing expense for the three months ended March 31, 2012, was \$23.7 million, an increase of \$6.8 million, or 40%, over costs of \$16.9 million for the three months ended March 31, 2011. This increase was primarily due to an increase in employee-related costs, including stock-based compensation expense, internal sales commissions and external partner channel commission of \$3.6 million due to an increase in headcount and external channel partners. Our sales and marketing headcount increased by 36% since March 31, 2011, as we hired additional sales personnel to focus on adding new customers and increasing penetration within our existing markets. The increase was also due to a \$3.1 million increase in travel-related expenses, consulting, online marketing, offline marketing and other marketing events.

*Research and Development Expense.* Research and development expense for the three months ended March 31, 2012, was \$7.2 million, an increase of \$2.1 million or 41% over research and development expense of \$5.1 million for the three months ended March 31, 2011. This increase was due to higher employee-related costs, including stock-based compensation expense, of \$1.9 million as a result of the increased headcount. Our research and development headcount increased 35% since March 31, 2011, as we hired additional research and development personnel in order to upgrade and extend our service offerings and develop new technologies.

*General and Administrative Expense.* General and administrative expense for the three months ended March 31, 2012, was \$16.2 million, an increase of \$4.5 million or 38%, over general and administrative expenses of \$11.7 million for the three months ended March 31, 2011. General and administrative expense for the three months ended March 31, 2012, included an increase of \$2.0 million due to higher employee-related costs, including stock-based compensation expense, as a result of the increased headcount. Our general and administrative headcount increased by 22% since March 31, 2011, as we added personnel to support our growth. The increase was also partially due to \$0.5 million in legal, audit, tax, consulting and insurance expenses and \$1.9 million in travel and expenses, recruiting, corporate events and infrastructure. During the three months ended March 31, 2012, we recognized an increase in general and administrative expense of \$2.2 million related to the change in fair value of the Anodyne contingent consideration based on an increase in probability that we will complete a successful cross-sell opportunity with a large prospect prior to the expiration of the contingent consideration on June 30, 2012. Unrelated, we recognized a decrease in general and administrative expense of \$2.1 million related to the first Proxsys contingent consideration based on an increase in probability that we will miss a minimum Coordinator service revenue threshold required for any payment to be made by 5-10%.

*Depreciation and Amortization Expense.* Depreciation and amortization expense for the three months ended March 31, 2012, was \$5.5 million, an increase of \$2.1 million or 61%, over depreciation and amortization expense of \$3.4 million for the three months ended March 31, 2011. This was primarily due to higher depreciation from fixed asset expenditures and software development costs in 2011.

*Income Tax Provision.* We recorded a provision for income taxes for the three months ended March 31, 2012, of approximately \$2.9 million, or an effective tax rate of 54%, compared to \$2.3 million, or an effective tax rate of 42%, for the three months ended March 31, 2011. The increase in our effective tax rate for the three months ended March 31, 2012 compared to the effective tax rate for the three months ended March 31, 2011 is primarily due to the impact from discrete items and other estimated higher permanent differences for the year ending December 31, 2012. The primary discrete item related to the tax impact of the change in fair value related to the Anodyne contingent consideration which is considered non-tax deductible goodwill and increased the rate for the three months period ended March 31, 2012 by 17%. This was offset by the net disqualification of ISO exercises of approximately 7%. The remaining increase was attributed to the effect of a permanent differences related to excess compensation.

**Liquidity and Capital Resources****Sources of Liquidity**

As of March 31, 2012 our principal sources of liquidity consisted of cash, cash equivalents and available-for-sale investments of \$133.6 million. Our cash investments consist of corporate debt securities, U.S. Treasury and government agency securities, and commercial paper. As specified in our investment policy, we place our investments in instruments that meet high credit quality standards, the policy limits the amount of our credit exposure to any one issue or issuer and seeks to manage these assets to achieve our goals of preserving principal, maintaining adequate liquidity at all times, and maximizing returns. As of March 31, 2012, we have no outstanding indebtedness. On October 20, 2011, we entered into a credit agreement which provides for a five-year \$100 million revolving credit facility. The credit facility can be increased by up to an additional \$100 million on the satisfaction of certain conditions, including obtaining lender commitments. There was no balance outstanding on the revolving credit facility during the three months ended March 31, 2012. The credit facility contains certain covenants, including consolidated leverage ratio and minimum fixed charges coverage ratios. The interest rates applicable to revolving loans under the credit agreement are at either (i) the British Bankers Association London Interbank Offered Rate ( LIBOR ) plus an interest margin based on our consolidated leverage ratio, or (ii) the base rate (which is the highest of (a) the bank's prime rate, (b) the Federal Funds rate plus 0.50%, and (c) one month LIBOR plus 1.00%) plus an interest margin based on our consolidated leverage ratio. We will pay a commitment fee during the term of the credit agreement which varies between 0.20% and 0.30% depending on the consolidated leverage ratio.

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We believe our sources of liquidity will be sufficient to sustain operations, to finance our strategic initiatives, to make payments on our contractual obligations, as well as our purchases of property and equipment for the foreseeable future. Our analysis is supported by the growth in our new customer base and a high rate of renewal rates with our existing customers and the corresponding increase in billings and collections. We may pursue acquisitions or investments in complementary businesses or technologies, in which case we may need to borrow against our revolving credit facility. There can be no assurance that we will continue to generate cash flows at or above current levels or that we will be able to maintain our ability to borrow under our existing credit facility or obtain additional financing.

**Table of Contents****Commitments**

We enter into various purchase commitments with vendors in the normal course of business. We believe that our existing sources of liquidity will be adequate to fund these purchases during the year 2012. In the normal course of business, we make representations and warranties that guarantee the performance of services under service arrangements with clients. Historically, there has been no material losses related to such guarantees.

**Operating Cash Flow Activities**

|  | For the Three Months Ended March 31, |          |
|--|--------------------------------------|----------|
|  | 2012                                 | 2011     |
| Net Income   | \$ 2,428                             | \$ 3,251 |
| Non-cash adjustments                                     | 9,832                                | 6,513    |
| Cash used in changes in operating assets and liabilities | (12,639)                             | (5,781)  |
| Net cash (used in) provided by operating activities      | \$ (379)                             | \$ 3,983 |

Cash flow from operations decreased approximately \$4.4 million to a net cash used in operating activities of \$0.4 million for the three months ended March 31, 2012, as compared to net cash provided by operating activities of \$4.0 million for the three months ended March 31, 2011. The change is mainly attributable to an increase in cash used in changes in operating assets and liabilities of \$6.9 million, offset by an increase in net income adjusted for non-cash adjustments of \$2.5 million. The increase in cash used in changes in operating assets and liabilities, was primarily a result of the payment of higher annual bonuses due to higher employee headcount and higher performance against the corporate scorecard. This amount is off-set by certain non-cash adjustment including an increase in stock-based compensation of \$1.6 million due to the timing of the issuance of our annual stock-based grants and an increase in depreciation and amortization expense of \$2.4 million. Additional non-cash adjustments include an increase in the reclassification of the excess tax benefit to financing activities of \$0.7 million and a decrease in net income of \$0.7 million which are both impacted by a higher effective tax rate due to a large discrete item in the three months ended March 31, 2012 compared to the same period in 2011.

**Investing Cash Flow Activities**

The cash used by investing activities increased by \$18.4 million to \$13.8 million from cash used by investing activities for the three months ended March 31, 2012, as compared to cash provided by investing activities of \$4.6 million for the three months ended March 31, 2011. Cash flows used in investing activities consist primarily of purchases of property and equipment, capitalized software development costs and our investment activities. We make investments in property and equipment and in software development on an ongoing basis. Our investment in equipment consists primarily of purchases of technology infrastructure to provide service stability and additional capacity to support our expanding client base. We had \$8.0 million in new equipment that was received in December 2011 which we paid for in the three months ended March 31, 2012. Our investment in software development consist of company managed-design, development, and testing of new application functionality with our less mature service offerings, which primarily include our athenaClinicals, athenaCommunicator and athenaCoordinator service offerings. Our capitalized software development increased by \$1.4 million for the three months ended March 31, 2012, compared to the three months ended March 31, 2011 primarily related to the new automation activities related to the new athenaCoordinator service offerings. The change of \$2.8 million in the decrease of restricted cash is due to the timing of the payments made for contingent consideration relating to an acquisition completed in 2009 and the net change in proceeds and purchases of our available for sale investments is based upon the changes in maturity of our investments in securities.

**Financing Cash Flow Activities**

The cash provided by financing activities was \$8.9 million for the three months ended March 31, 2012, compared to cash provided by financing activities \$0.9 million for the three months ended March 31, 2011. The change is primarily attributable to \$5.8 million increase in cash received from the exercise of stock options during the three months ended March 31, 2012 compared to the three months ended March 31, 2011. This increase was offset by an increase of \$1.8 million related to the cash paid to settle tax obligations through the net settlement option that our employees can elect when restricted stock units vest in the three months period ended March 31, 2012. In the three months ended March 31, 2011, we had payments on debt and a large payment of contingent consideration which was accrued at acquisition date relating to the Anodyne acquisition. We elected to repay all of our outstanding debt balances under our equipment line of credit and term loan, as well as terminate our related interest rate derivative in May 2011.



**Table of Contents****Contractual Obligations**

We have contractual obligations under our operating leases for properties. The following table summarizes our long-term contractual obligations and commitments as of March 31, 2012:

|                             | Total            | Payments Due by Period |                  |                 |                 | Other           |
|-----------------------------|------------------|------------------------|------------------|-----------------|-----------------|-----------------|
|                             |                  | Less than 1 Year       | 2 - 3 Years      | 4 -5 Years      | After 5 years   |                 |
| Operating lease obligations | \$ 31,858        | \$ 6,716               | \$ 14,057        | \$ 5,504        | \$ 5,581        | \$              |
| Other                       | 1,685            |                        |                  |                 |                 | 1,685           |
| <b>Total</b>                | <b>\$ 33,543</b> | <b>\$ 6,716</b>        | <b>\$ 14,057</b> | <b>\$ 5,504</b> | <b>\$ 5,581</b> | <b>\$ 1,685</b> |

The commitments under our operating leases shown above consist primarily of lease payments for our Watertown, Massachusetts, headquarters; our Rome, Georgia, offices; our Alpharetta, Georgia, offices; Birmingham, Alabama, offices; and our Chennai, India, offices.

Other amount consists of uncertain tax benefits. We have not utilized these uncertain tax benefits, nor do we have an expectation of when these uncertain tax benefits would be challenged. As of March 31, 2012, we cannot reasonably estimate when any future cash outlays would occur related to these uncertain tax positions.

**Off-Balance Sheet Arrangements**

As of March 31, 2012 and 2011, and December 31, 2011, we did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. Other than our operating leases for office space, we do not engage in off-balance sheet financing arrangements.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk.**

*Foreign Currency Exchange Risk.* Our results of operations and cash flows are subject to fluctuations due to changes in the Indian rupee. None of our consolidated revenues are generated outside the United States. None of our vendor relationships, including our contracts with our offshore service providers International Business Machines Corporation and Vision Business Process Solutions, Inc., a subsidiary of Dell, Inc. (formerly Perot Systems Corporation), for work performed in India and the Philippines, is denominated in any currency other than the U.S. dollar. For the three months ended March 31, 2012, less than 1% of our expenses occurred in our direct subsidiary in Chennai, India, and was incurred in Indian rupees. We therefore believe that the risk of a significant impact on our operating income from foreign currency fluctuations is not substantial.

*Interest Rate Sensitivity.* We had unrestricted cash, cash equivalents and available for sale investments totaling \$133.6 million at March 31, 2012. These amounts are held for working capital purposes and were invested primarily in deposits, money market funds, and short-term and long-term, interest-bearing, investment-grade securities. Due to the short and expected term of these investments, we believe that we do not have any material exposure to changes in the fair value of our investment portfolio as a result of changes in interest rates. The value of these securities, however, will be subject to interest rate risk and could fall in value if interest rates rise.

*Interest Rate Risk.* As of March 31, 2012, we had no outstanding long-term debt and capital lease obligations and there were no amounts outstanding under the revolving credit facility.

**Item 4. Controls and Procedures.****Disclosure Controls and Procedures**

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in the reports that we file or submit under the Securities and Exchange Act of 1934 is (1) recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms and (2) accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosure. As of March 31, 2012 (the Evaluation Date), our management, with

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the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities and Exchange Act of 1934). Our management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives, and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Our Chief Executive Officer and Chief Financial Officer have concluded based upon the evaluation described above that, as of the Evaluation Date, our disclosure controls and procedures were effective at the reasonable assurance level.

**Table of Contents****Changes in Internal Control**

There have been no changes in our internal control over financial reporting for the quarter ended March 31, 2012, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**PART II OTHER INFORMATION****Item 1. Legal Proceedings.*****Prompt Medical Systems, L.P.***

On March 2, 2010, a complaint was filed by Prompt Medical Systems, L.P. naming the Company and several other defendants in a patent infringement case (*Prompt Medical Systems, L.P. v. AllscriptsMisys Healthcare Solutions, Inc. et al.*, Civil Action No. 6:2010cv00071, United States District Court for the Eastern District of Texas). The complaint alleges that the Company has infringed U.S. Patent No. 5,483,443 with a listed issue date of January 9, 1996, entitled Method for Computing Current Procedural Terminology Codes from Physician Generated Documentation. The complaint seeks an injunction enjoining infringement, damages, and pre- and post-judgment costs and interest. In March 2012, the plaintiff, the Company, and two other defendants entered into a confidential settlement agreement which provided for, among other things, a complete and final settlement of all claims between the parties for certain releases, covenants not to sue, and a license with respect to the claims of the patent to sell and provide the Company's services. The Company was indemnified in this lawsuit from and against any liability, pursuant to a license agreement with one of its vendors. On March 27, 2012, the Court dismissed all claims and counterclaims between the Company and the other parties to the settlement agreement.

***PPS Data, LLC***

On July 28, 2011, a complaint was filed by PPS Data, LLC naming the Company in a patent infringement case (*PPS Data, LLC v. athenahealth, Inc.*, Civil Action No. 3:11-cv-00746, United States District Court for the Middle District of Florida). The complaint alleges that the Company has infringed U.S. Patent No. 6,343,271 with a listed issue date of January 29, 2002, entitled Electronic Creation, Submission, Adjudication, and Payment of Health Insurance Claims (the 271 Patent). The complaint seeks an injunction enjoining infringement, damages, pre- and post-judgment costs and interest, and attorneys' fees. On September 8, 2011, the Company filed a motion to dismiss, or, in the alternative, a motion for summary judgment. On October 18, 2011, the plaintiff filed a motion for leave to amend its complaint to allege that the Company has infringed on U.S. Patent No. 6,341,265 with a listed issue date of January 22, 2002, entitled Provider claim editing and settlement system, and U.S. Patent No. 7,194,416 with a listed issue date of March 20, 2007, entitled Interactive creation and adjudication of health care insurance claims. The Court granted the plaintiff's motion for leave to amend its complaint on December 21, 2011, and on December 23, 2011, the plaintiff filed its amended complaint. On December 27, 2011, the Company filed a motion to dismiss, or, in the alternative, a motion for summary judgment of non-infringement with respect to the 271 Patent. On December 29, 2011, the United States Patent and Trademark Office granted the Company's request for reexamination of the 271 Patent. On January 9, 2012, the Company filed a motion to stay the case pending completion of the patent reexamination, and on March 1, 2012, the Court granted the Company's motion to stay the case. The Company believes that it has meritorious defenses to the amended complaint and will continue to contest the claims vigorously.

***Medsquire, LLC***

On December 6, 2011, a complaint was filed by Medsquire, LLC against the Company in a patent infringement case (*Medsquire, LLC v. athenahealth, Inc.*, Civil Action No. 2:11-CV-10126-JHN-PLA, United States District Court for the Central District of California). The complaint alleges that the Company has infringed U.S. Patent No. 5,682,526 with a listed issue date of October 28, 1997, entitled Method and System for Flexibly Organizing, Recording, and Displaying Medical Patient Care Information Using Fields in a Flowsheet. The complaint seeks damages, pre-judgment interest, and attorneys' fees. The Company believes that it has meritorious defenses to the complaint and will contest the claims vigorously.

***AdvancedMD Software, Inc.***

On July 18, 2011, the Company filed a complaint against AdvancedMD Software, Inc. in the United States District Court for the District of Massachusetts. The complaint alleges that AdvancedMD Software, Inc. has infringed two of the Company's U.S. Patents: No. 7,617,116, which was issued on November 10, 2009, for Practice Management and Billing Automation System and No. 7,720,701, which was issued on May 18, 2010, for Automated Configuration of Medical Practice Management Systems. The Company is seeking permanent injunctive relief, damages, pre- and post-judgment costs and interest, and attorneys' fees.

*Cordjia, LLC*

On July 18, 2011, a complaint was filed in the Superior Court for Waldo County, Maine, against the Company entitled *Cordjia, LLC v. athenahealth, Inc.* The complaint alleges that the Company entered into a partnership with the plaintiff to purchase property in Maine, that the parties entered into a mutual non-disclosure agreement governing the sharing of confidential information between them, and that the Company subsequently terminated the partnership and purchased the property itself, using the confidential information obtained from the plaintiff to do so. The complaint purports to state claims for common-law fraud, negligent

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misrepresentation, breach of fiduciary duty, unjust enrichment, *quantum meruit*, promissory estoppel, breach of contract, and violation of the Maine Uniform Trade Secrets Act. The complaint seeks unspecified damages, fees and costs, and injunctive relief enjoining the Company from making further use of the plaintiff's confidential information and requiring the Company to return all confidential information in its possession to the plaintiff. On August 8, 2011, the Company filed a motion to dismiss for improper venue. On November 17, 2011, the Court granted the Company's motion to dismiss for improper venue as to the claims for unjust enrichment, *quantum meruit*, breach of contract, and violation of the Maine Uniform Trade Secret Act, and denied the Company's motion as to the other claims. On December 7, 2011, the plaintiff filed an amended complaint, and on December 19, 2011, the Company filed a motion to dismiss the remaining claims, or in the alternative, to stay the proceeding. On March 22, 2012, the Court granted the Company's motion to stay the Maine proceedings pending the Delaware case noted below.

On December 7, 2011, a complaint was filed in the Superior Court for New Castle County, Delaware, against the Company entitled *Cordjia, LLC v. athenahealth, Inc.* The complaint pertains to the same facts as stated above and alleges claims for breach of contract, unjust enrichment, *quantum meruit*, and violation of the Delaware Uniform Trade Secrets Act. The complaint seeks unspecified damages, fees and costs, an injunction enjoining the Company from making any further use of the confidential information, and an order requiring the Company to return any copies of confidential information. On February 2, 2012, the Company filed a motion to dismiss the complaint. On March 30, 2012, the Court held oral argument on the Company's motion to dismiss.

The Company believes that it has meritorious defenses to the complaints and intends to contest the claims vigorously.

***Kickapoo Run, LLC***

On September 16, 2011, a complaint was filed by Kickapoo Run, LLC naming the Company and several other defendants in a patent infringement case (*Kickapoo Run, LLC v. athenahealth, Inc. et al.*, Civil Action No. 1:99-mc-09999, United States District Court for the District of Delaware). The complaint alleges that the Company has infringed U.S. Patent No. 5,961,332 with a listed issue date of October 5, 1999, entitled Apparatus for Processing Psychological Data and Method of Use Thereof. The complaint seeks an injunction enjoining infringement, damages, costs, expenses, pre- and post-judgment interest, and attorneys' fees. The Company believes that it has meritorious defenses to the complaint and will contest the claims vigorously.

In addition, from time to time the Company may be subject to other legal proceedings, claims, and litigation arising in the ordinary course of business. The Company does not, however, currently expect that the ultimate costs to resolve any pending matter will have a material effect on the Company's consolidated financial position, results of operations, or cash flows.

**Item 1A. Risk Factors.**

During the three months ended March 31, 2012, there were no material changes to the risk factors that were disclosed in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2011.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.**

Not applicable.

**Item 3. Defaults Upon Senior Securities.**

Not applicable.

**Item 4. Mine Safety Disclosures.**

None.

**Item 5. Other Information.**

Not applicable.

**Item 6. Exhibits.**

(a) Exhibits.

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### Exhibit

| No.       | Exhibit Index  |
|-----------|--|
| 31 .1*    | Rule 13a-14(a) or 15d-14 Certification of Chief Executive Officer  |
| 31 .2*    | Rule 13a-14(a) or 15d-14 Certification of Chief Financial Officer  |
| 32 .1*    | Certifications of Chief Executive Officer and Chief Financial Officer pursuant to Exchange Act rules 13a-14(b) or 15d-14(b) and 18 U.S.C. Section 1350 |
| 101.INS** | XBRL Instance Document   |

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|           |                                     |
|-----------|-------------------------------------|
| 101.SCH** | XBRL Schema Document                |
| 101.CAL** | XBRL Calculation Linkbase Document  |
| 101.LAB** | XBRL Labels Linkbase Document       |
| 101.PRE** | XBRL Presentation Linkbase Document |
| 101.DEF** | XBRL Definition Linkbase Document   |

\* Furnished herewith

\*\* Extensible Business Reporting Language (XBRL) information is furnished and deemed not filed or a part of a registration statement or prospectus for purposes of sections 11 or 12 of the Securities Act of 1933, or section 18 of the Securities Exchange Act of 1934, and otherwise is not subject to liability under these sections.

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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

ATHENAHEALTH, INC.

By: /s/Jonathan Bush  
Jonathan Bush  
Chief Executive Officer, President, and Chairman

By: /s/Timothy M. Adams  
Timothy M. Adams,  
Chief Financial Officer, Senior Vice President

Date: April 26, 2012