

HEALTHSTREAM INC  
Form 10-K  
March 23, 2011



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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       Smaller reporting company

(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes  No   
The aggregate market value of the Common Stock issued and outstanding and held by non-affiliates of the Registrant, based upon the closing sales price for the Common Stock on the NASDAQ Global Market on June 30, 2010 was \$71,681,232. All executive officers and directors of the registrant have been deemed, solely for the purpose of the foregoing calculation, to be affiliates of the registrant.

As of March 22, 2011, there were 21,931,535 shares of the Registrant's common stock outstanding.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the Registrant's definitive Proxy Statement for its 2011 Annual Meeting of Shareholders are incorporated by reference into Part III hereof.

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**PART I**

This Annual Report on Form 10-K contains forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934. Such forward-looking statements include, among others, those statements including the words expects, anticipates, intends, believes, may, will, should, continue and similar language or the such terms or other comparable terminology. Although we believe that the expectations reflected in the forward-looking statements are reasonable, HealthStream's actual results may differ significantly from those projected in the forward-looking statements. Factors that might cause or contribute to such differences include, but are not limited to, those discussed in the section Risk Factors in Item 1A of this Annual Report on Form 10-K and elsewhere in this document. In addition, factors that we are not currently aware of could harm our future operating results. You should carefully review the risks described in other documents HealthStream files from time to time with the Securities and Exchange Commission. You are cautioned not to place undue reliance on forward-looking statements, which speak only as of the date of this Annual Report on Form 10-K. HealthStream undertakes no obligation to publicly release any revisions to the forward-looking statements or reflect events or circumstances after the date of this document.

**Item 1. Business**

**OVERVIEW AND HISTORY**

HealthStream, Inc. (HealthStream or the Company) provides Internet-based learning and research solutions for healthcare organizations all designed to assess and develop the people that deliver patient care which, in turn, supports the improvement of business and clinical outcomes. Our learning products are used by healthcare organizations to meet a broad range of their training, certification, and development needs, while our research products provide our customers information about patients' experiences, workforce engagement, physician relations, and community perceptions of their services. HealthStream's customers include healthcare organizations, pharmaceutical and medical device companies, and other participants in the healthcare industry. Our customer base across both our learning and research business units includes over 2,500 healthcare organizations (predominately acute-care facilities) throughout all 50 states of the United States.

The Company's core learning product is the HealthStream Learning Center<sup>®</sup> (HLC), our proprietary learning platform provided through the Internet via software-as-a-service. At December 31, 2010, HealthStream had approximately 2.45 million contracted, primarily hospital-based subscribers, to the HLC. We deliver educational activities and training courseware to our customers through the HLC platform. Our research products and service offerings include quality and satisfaction surveys, data analyses of survey results, and other research-based measurement tools focused on patients, physicians, employees, and members of the community. The Company's core research product is the Patient Insights survey, which accounts for approximately half of our research product business.

Headquartered in Nashville, Tennessee, the Company was incorporated in 1990 and began providing its Internet-based solutions in 1999 and its survey and research solutions in 2005. Including an additional office in Laurel, Maryland, HealthStream had 356 full-time and 76 part-time employees as of December 31, 2010. HealthStream has evolved from a company with an initial focus on technology-based training to a company providing outcomes-focused learning and research solutions to the nation's healthcare providers.

**INDUSTRY BACKGROUND**

According to the deputy director of the National Health Statistics Group at the Centers for Medicare and Medicaid Services (CMS), spending in the healthcare industry reached approximately \$2.5 trillion in 2009, or 17.6 percent of the gross domestic product. Hospital care expenditures accounted for approximately 30 percent of the \$2.5 trillion industry. Approximately 14.3 million professionals are employed in the healthcare segment of the domestic economy, with approximately 5.3 million employed in acute-care hospitals, our target market for our learning and research products. As of December 31, 2010, approximately 2.45 million, or 46 percent, of these healthcare professionals were contracted to use our Internet-based HLC platform.

All of the 5.3 million hospital-based healthcare professionals that work in the nation's approximately 5,000 acute-care hospitals are required by federal mandates and accrediting bodies to complete training in a number of areas. This training includes safety training mandated by both the Occupational Safety and Health Administration (OSHA) and The Joint Commission (an independent, not-for-profit organization that accredits and certifies healthcare organizations

and programs in the United States), as well as training on patient information confidentiality required under the Health Insurance Portability and Accountability Act (HIPAA).

In hospitals, staffing issues and personnel shortages have also contributed to the need for facility based workforce development as well as additional assessment and competency based training. For example, the American Hospital Association (AHA) s report Workforce 2015: Strategy Trumps Shortage (January 2010) indicates that the shortfall of registered nurses in 2025 will be 260,000 FTEs and the shortage of physicians in 2020 will be 109,000. We believe that offering training and education for hospital personnel is increasingly being utilized as a retention and recruitment incentive.

Many healthcare professionals use continuing education to keep abreast of the latest developments and meet licensing, certification, and credentialing requirements. Continuing education requirements include continuing education for nurses, emergency medical services

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personnel, first responder personnel, radiologic personnel, and physicians. Pharmaceutical and medical device companies must also provide their medical industry sales representatives with training mandated for the healthcare industry and training for new products. Such companies also provide support for education and training for those audiences that use their products in healthcare organizations.

A large portion of the nation's hospitals utilize research and survey tools to gain valuable insight about patients' experiences, to assess workforce competency and engagement, to determine the status of physician relations, and to measure the perceptions about the hospitals in the communities they serve. Industry-wide, interest is increasing in research, due, in part, to the CAHPS® (Consumer Assessment of Healthcare Providers and Systems) Hospital Survey launched by CMS in partnership with the Agency for Healthcare Research and Quality (AHRQ). Hospitals must submit data to CMS for certain required quality measures which for inpatients includes the CAHPS® Hospital Survey in order to receive the full market basket increase to their reimbursement payment rates from CMS. Hospitals that fail to submit this survey data will incur a reduction of two percentage points in the inpatient market basket update amount for the following federal fiscal year. We are designated as a certified vendor and offer CAHPS® Hospital Survey services.

Finally, the hospital industry continues to operate under intense pressure to reduce costs as a result of reductions in government reimbursement rates and increased focus on cost containment consistent with participation of patients in managed care programs. In addition, hospitals, as well as pharmaceutical and medical device companies, continue to experience rising operating costs, coupled with increased pressure to measure and report on the outcomes of the dollars spent on training. Our products and services are designed to meet these needs by reducing healthcare organizations' costs of training while improving learning outcomes, enhancing reporting capabilities, and supporting customers' business objectives.

### **HEALTHSTREAM'S SOLUTIONS**

HealthStream's products and services are organized into two segments, 1) HealthStream Learning and 2) HealthStream Research, which collectively help healthcare organizations meet their ongoing training, education, assessment, and compliance needs. Our objective is to better support our healthcare organization customers in their efforts to transform insight into action as they measure and benchmark key data points for their constituencies and then to incorporate the results into training and improvement programs through our learning products.

#### **HealthStream Learning**

Within HealthStream Learning, we bring training and education content together with administrative and management tools through our Internet-based platforms, the HealthStream Learning Center® and a more streamlined version, HealthStream Express. We offer our Internet-based platform customers a wide array of additional courseware subscriptions. Our learning management system supports healthcare administrators in configuring training to meet the precise needs of different groups of employees, modifying training materials, and documenting that training has been completed. At December 31, 2010, 2.45 million healthcare professionals had contracted subscriptions for our Internet-based HLC services. Pricing for the HLC is subscription based, with fees based on the number of subscribers, courseware provided, and other factors. We offer training, implementation, and account management services to facilitate adoption of our platform. Fees for training are based on the time and efforts of the personnel involved. Implementation fees vary based on the size, scope, and complexity of the project.

Our Internet-based platform and our courseware are hosted in a central data center that allows authorized subscribers Internet access to our services, thereby eliminating the need for onsite local implementations of installed learning management products.

Along with the Internet-based HLC, we also offer healthcare organizations full-service capabilities to create online courses by converting their existing course material, self-author new materials through our Authoring Center product, and electively share these materials with other HealthStream customers through a courseware exchange. We also offer Authoring Pro, an upgraded product which includes an industry leading image library, owned by A.D.A.M., Inc., as an additional subscription to this product. Pricing for these products is subscription based, with fees based on the number of subscribers and level of penetration of services.

The HealthStream Competency Center (HCC), our software-as-a-service competency management solution for healthcare organizations, allows us to offer our customers tools to assess competency and appraise performance.

Competency assessment is a requirement of hospitals and healthcare organizations for maintaining accreditation, based on requirements from The Joint Commission to evaluate, document, and report performance competencies. We believe that the HCC offers an effective means of determining which competencies are associated with each position and evaluating and documenting competency assessments.

During 2010, we released a set of significant enhancements to the HCC. These enhancements included features to enable large, multi-facility enterprises to more effectively manage competency and performance initiatives across all of their facilities and will, therefore, serve the growing competency management needs of our larger customers. HealthStream and Laerdal Medical A/S, a Norwegian limited stock company formed a collaborative arrangement in 2010 named SimVentures to offer products and services aimed at accelerating the global adoption of simulation-based learning by healthcare providers with a focus on improving clinical competencies and patient outcomes. The new venture will offer healthcare organizations and medical & nursing schools, worldwide, a range of fully integrated software-as-a-service applications that accelerate development and distribution of simulation content; enable enterprise-wide management of simulation centers, simulators, and programs; and support assessment of the



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effectiveness of simulation training as part of complete curricula. Our new simulation management platform, SimCenter , was announced in January 2011 and will be launched at a later date in 2011.

Through HospitalDirect , we develop, manage, and distribute online, print education, and training activities for provider-based healthcare professionals and physicians, as well as online education and training activities for sales representatives. Certain of the education activities we develop and distribute provide continuing education credit for healthcare professionals completing them. Pricing for these products varies based on the size, scope, and nature of the project. Most of these activities are supported by either pharmaceutical or medical device companies.

Our strategy for HealthStream Learning is to continue adding subscribers to our Internet-based HLC, while expanding penetration of courseware offerings to existing accounts, providing add-on software applications (e.g. HCC, Authoring Center, SimCenter, etc.), developing new tools, and penetrating other professional services across our customer base.

**HealthStream Research**

HealthStream Research complements HealthStream Learning 's product and service offerings by providing hospital-based customers with Patient Insights , Employee Insights , Physician Insights , and Community Insights surveys, data analyses of survey results, and other research-based measurement tools. Our services are designed to provide thorough analyses with insightful recommendations for change; to provide benchmarking capability using our comprehensive databases; and to provide consulting services to identify solutions for our customers based on their survey results. Clients are able to access and analyze their survey results data through Insights Online , our secure web-based reporting platform. Our survey and research solutions focus on providing industry-leading, statistically valid data to assist our customers with their decision making related to their organization 's performance improvement objectives. In addition to collecting and reporting data, we provide expert analysis and consulting to help customers understand their survey results and the underlying impact on their business. It is with this insight that healthcare organizations are able to develop plans for improved performance that is able to be delivered through HealthStream 's learning solutions. Pricing for these services is based on the survey type, delivery method, size of the survey instrument, sample size, frequency of survey cycles, and other factors.

To further support our customers, HealthStream offers the HealthStream Improvement Center , an online system for hospital leaders to optimize and accelerate the execution of improvement plans including those plans based on results from patient, employee, physician, and community surveys. The Improvement Center is one among a storehouse of solutions from HealthStream Research that include a comprehensive line of survey products, national benchmarks, HCAHPS Improvement Library, consulting services, and other support tools.

Our strategy for HealthStream Research includes continuing to grow our customer base, expanding the products and services provided to each customer, and introducing HealthStream Learning solutions to address survey research findings. We will continue to expand our offering of research and assessment tools that are aligned with healthcare quality initiatives and continuous improvement efforts.

**CUSTOMERS**

We provide our learning and research solutions to customers across a broad range of entities within the healthcare industry, including healthcare organizations (including government entities) and pharmaceutical and medical device companies. We derive a substantial portion of our revenues from a relatively small number of customers, although no single customer represented more than 10 percent of our revenues during 2010, 2009, or 2008. Examples of customers that have purchased or contracted for products and services from HealthStream include: HCA, Inc., Tenet Healthcare Corporation, Catholic Health Initiatives, Community Health Systems, Inc., Lifepoint Hospitals, Inc., Ardent Health Services, LLC, and Baxter Healthcare Corporation.

**SALES AND MARKETING**

We market our products and services primarily through our direct sales teams, our consultants, and our account relationship managers, who are based at our corporate headquarters in Nashville, Tennessee and in our additional office located in Laurel, Maryland, as well as remote home office sales locations. As of December 31, 2010, our HealthStream Learning sales and relationship management personnel consisted of 54 employees of which 45 carried sales quotas and our HealthStream Research sales and consultant personnel consisted of 25 employees of which 15 carried sales quotas. As of December 31, 2009, our HealthStream Learning sales and relationship management

personnel consisted of 49 employees of which 40 carried sales quotas and our HealthStream Research sales and consultant personnel consisted of 22 employees of which 12 carried sales quotas. Our geographically dispersed field sales organization is divided into one team focused on selling our learning products and a separate sales team focused on selling our research products. In addition to sales professionals, we also employ strategic account personnel that manage our largest customer relationships as well as account relationship managers and consultants who work to develop and expand relationships, including contract renewals.

We conduct a variety of marketing programs to promote our products and services, including product catalogs, user groups including our annual customer Summit, trade shows, online promotion and demonstrations, telemarketing campaigns, public relations, distribution of product-specific literature, direct mail, and advertising.

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Over most of the last ten years, we have hosted a conference in Nashville for our customers known as The Summit. We have utilized this client conference to reach out to existing and potential customers and business partners, provide training and educational services, and demonstrate our new and existing product offerings. We have marketing teams that are responsible for these initiatives and for working with and supporting our product management and sales teams. At December 31, 2010, our marketing personnel consisted of 16 employees.

### **OPERATIONS**

We believe our ability to establish and maintain long-term customer relationships, adoption of our products and services, recurring sales, and development and maintenance of new and existing products are dependent on the strength of our operations, customer service, product development and maintenance, training, and other support teams. As of December 31, 2010, these personnel consisted of approximately 100 employees for our Learning segment and approximately 206 employees for our Research segment, of which 127 employees worked in our interviewing center. Our Learning operations team consists of personnel associated with customer support, implementation services, product development and maintenance, training, and project management. Our Research operations team consists of personnel associated with phone interviewing, distributing and processing paper-based survey instruments, data analysis and reporting of survey results, and project management.

### **TECHNOLOGY MANAGEMENT**

Our services are designed to be reliable, secure, and scalable. Our software is a combination of proprietary and commercially available software and operating systems. Our software supports hosting and management of content, publication of our web sites, execution of courseware, registration and tracking of users, collection, sampling, and analysis of survey data, and reporting of information for both internal and external use. We designed the platforms that provide our services to allow each component to be independently scaled by adding commercially available hardware and a combination of commercially available and proprietary software components.

Our software applications, servers, and network infrastructure that deliver the majority of our services are hosted by third party data center providers. Our primary data center is located at a tier-four rated hosting facility in Chicago, Illinois, and our disaster recovery data center is hosted by a separate provider located in Franklin, Tennessee. Both of our providers maintain our equipment in secure, limited access environments, supported by redundant power, environmental conditioning, and network connectivity. Our providers' hosting centers are connected to the Internet through multiple, redundant, high-speed fiber optic circuits. The transactional systems supporting the data collection for our survey products are located in secure, limited access environments located at our Nashville, Tennessee and Laurel, Maryland offices and feed our core business intelligence platforms supporting our survey products located at our primary hosting facility in Chicago. Company personnel monitor all servers, networks, and systems on a continuous basis. Together with our providers, we employ several levels of enterprise firewall systems and data abstraction to protect our databases, customer information, and courseware library from unauthorized access. All of our production data located in our Chicago data center is backed up in real time to our disaster recovery data center. Monthly snap-shots of our data are stored off site with a third party data storage provider.

### **COMPETITION**

The healthcare education industry is highly fragmented, varies significantly in delivery methods (*i.e.*, written materials, live events, video, CD-ROM products, manikins, and online products), and is composed of a wide variety of entities competing for customers. The sheer volume of healthcare information available to satisfy continuing education needs, rapid advances in medical developments, and the time constraints that healthcare professionals face make it difficult to quickly and efficiently access the continuing education content most relevant to an individual's practice or profession. Historically, healthcare professionals have received continuing education and training through offline publications, such as medical journals and CD-ROMs, and by attending conferences and seminars. In addition, other healthcare workers and pharmaceutical and medical device manufacturers' sales and internal regulatory personnel usually fulfill their education and training needs through instructor-led programs from external vendors or internal training departments. While these approaches satisfy the ongoing education and training requirements, they are typically costly and inconvenient. In addition, live courses are often limited in the breadth of offerings and do not provide a method for tracking training completion. The results of these traditional methods, both from a business and compliance standpoint, are difficult to track and measure. While hospitals and health systems occasionally survey

their patients, physicians, and employees using their own internal resources, the practice is limited since they do not typically possess the valuable comparative benchmarking data that is available from independent survey research vendors.

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In addition to the competing delivery methods described above, we also have direct competitors. A number of companies offer competitive learning management products to the healthcare industry. We compete with learning management system providers such as SABA, Taleo, Plateau Systems, Cornerstone OnDemand, and SumTotal Systems that provide their services to multiple industries, including healthcare. We also compete with large medical publishers that have operating units that offer learning management systems that focus on healthcare, including Cengage Learning's Net Learning and Reed Elsevier Group's MC Strategies. In the survey business, we see competition from large nationally recognized survey research firms such as Press Ganey Associates, National Research Corporation, Gallup, and others. Our survey business also experiences direct competition from vendors who provide survey research services to other industries including Kenexa and Foresight. Finally, in our SimVentures joint venture, we expect to compete with B-Line Medical, CAE, and Medical Education Technologies, Inc.

We believe our learning solutions, which include both products and services that facilitate training for healthcare professionals, a wide assortment of courseware, a mechanism for measuring satisfaction and/or other results, and the ability to provide all our services on a single platform over the Internet, provide us with a competitive advantage. In our survey research business, we believe our large proprietary database of survey results, technology infrastructure designed to automate the processing of survey results, proprietary core survey instruments and action plan development methodology, and our ability to quickly deliver relevant online courseware targeted at addressing survey related findings provide us with a competitive advantage. We believe that the principal competitive factors affecting the marketing of our learning and research solutions to the healthcare industry include:

- features of the HLC product, including reporting, management functionality, ability to manage a variety of events or modalities, courseware assignment, curriculum management, scalability, and the ability to track utilization and results;

- scope and variety of Internet-based learning courseware available, including mandated content for OSHA, The Joint Commission, patient safety, and HIPAA requirements, competency-based content, as well as the ability of our customers to create and host their own web-enabled courseware;

- our singular focus on the healthcare industry and our deep healthcare expertise;

- scope and quality of professional services offered, including survey execution, implementation, benchmarking, training and the expertise and technical knowledge of the customers' employees;

- competitive pricing, which supports a return on investment when compared to other alternative delivery methods;

- customer service and support;

- effectiveness of sales and marketing efforts; and

- company reputation.

Collectively, we believe these capabilities provide us with the ability to improve the quality of healthcare by assessing and developing the people who deliver care.

## **GOVERNMENT REGULATION OF THE INTERNET AND THE HEALTHCARE INDUSTRY**

### **Regulation of the Internet and the Privacy and Security of Personal Information**

The laws and regulations that govern our business change rapidly. For example, the United States government and the governments of some states and foreign countries have attempted to regulate activities on the Internet. The following are some of the evolving areas of law that are relevant to our business:

- Privacy and Security Laws.* Current and proposed federal, state and foreign privacy and security regulations and other laws restricting the collection, use, security and disclosure of personal information could limit our ability to collect information or use and disclose the information in our databases or derived from other sources

to generate revenues. It may be costly to implement security or other measures designed to comply with any new legislation. For example, the American Recovery and Reinvestment Act of 2009 (ARRA) has expanded the application of certain HIPAA privacy and security requirements to apply directly to us as a business associate of our customers.

*Encryption Laws.* Many copyright owner associations have lobbied the federal government for laws requiring copyrighted materials transmitted over the Internet to be digitally encrypted in order to track rights and prevent unauthorized use of copyrighted materials. If these laws are adopted, we may incur substantial costs to comply with these requirements or change the way we do business.

*Content Regulation.* Both foreign and domestic governments have adopted and proposed laws governing the content of material transmitted over the Internet. These include laws relating to obscenity, indecency, libel and defamation. We could be liable if content delivered by us violates these regulations.

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*Information Security Accountability Regulation.* As a business associate of our customers, we are required to report certain breaches of unsecured protected health information to our customers, which must in turn notify affected individuals, HHS and, in certain situations involving large breaches, the media. In addition, we are subject to certain state laws that relate to privacy or the reporting of security breaches that are more restrictive than the requirements of AARA. For example, California has enacted legislation requiring disclosure of security breaches involving personal information and medical information. We may incur costs to comply with these security requirements. Because many of these laws are new and there is little guidance related to many of these laws, it is difficult to estimate the cost of our compliance with these laws. Further, Congress has considered bills that would require companies to engage independent third parties to audit the companies computer information security. If the Company is required to make a public announcement regarding a breach of security or if one of the Company's customers is required to make a public announcement in connection with a breach of security by the Company, the Company's business could be negatively impacted.

*Sales and Use Tax.* Through December 31, 2010, we collected sales, use or other taxes on taxable transactions in all states in which we have employees or have a significant level of sales activity. While HealthStream expects that this approach is appropriate, other states or foreign jurisdictions may seek to impose tax collection obligations on companies like us that engage in online commerce. If they do, these obligations could limit the growth of electronic commerce in general and limit our ability to profit from the sale of our services over the Internet.

Laws and regulations directly applicable to e-commerce, Internet communications, and the privacy and security of personal information are becoming more prevalent. Congress continues considering laws regarding Internet taxation. The dynamic nature of this regulatory environment increases the uncertainty regarding the marketplace impact of such regulation. The enactment of any additional laws or regulations may increase our cost of conducting business or otherwise harm our business, financial condition and operating results.

**Regulation of Education, Training and Other Services for Healthcare Professionals**

*Occupational Safety and Health Administration (OSHA).* OSHA regulations require employers to provide training to employees to minimize the risk of injury from various potential workplace hazards. Employers in the healthcare industry are required to provide training with respect to various topics, including blood borne pathogens exposure control, laboratory safety and tuberculosis infection control. OSHA regulations require employers to keep records of their employees' completion of training with respect to these workplace hazards.

*The Joint Commission.* The Joint Commission mandates that employers in the healthcare industry provide certain workplace safety and patient interaction training to employees. Training required by The Joint Commission may include programs on infection control, patient bill of rights, radiation safety, and incident reporting. Healthcare organizations are required to provide and document training on these topics to receive accreditation from The Joint Commission. In addition, The Joint Commission imposes continuing education requirements on physicians that relate to each physician's specific staff appointments.

*Health Insurance Portability and Accountability Act (HIPAA).* HIPAA regulations require certain organizations, including most healthcare providers and health plans, to adopt safeguards regarding the use and disclosure of health-related information. HIPAA regulations also require organizations that maintain or transmit health information electronically in connection with certain transactions to provide reasonable and appropriate safeguards to protect the privacy, integrity and confidentiality of individually identifiable healthcare information. These healthcare organizations are required to establish, maintain and provide training with regard to their policies and procedures for protecting the integrity and confidentiality of individually identifiable healthcare information. Healthcare organizations are required to document training on these topics to support their compliance. ARRA expanded the application of certain HIPAA privacy and security requirements to apply directly to companies (known as business associates) that provide services to certain healthcare organizations.

*The American Nurses Credentialing Center (ANCC).* ANCC, a subsidiary of the American Nurses Association (ANA), provides individuals and organizations throughout the nursing profession with the resources they need to achieve practice excellence. ANCC's internationally renowned credentialing programs certify nurses in specialty

practice areas; recognize healthcare organizations for promoting safe, positive work environments through the Magnet Recognition Program® and the Pathway to Excellence® Program; and accredit providers of continuing nursing education. In addition, ANCC's Institute for Credentialing Innovation® offers an array of informational and educational services and products to support its core credentialing programs. ANCC certification exams validate nurses' skills, knowledge, and abilities. More than a quarter million nurses have been certified by ANCC since 1990. More than 80,000 advanced practice nurses are currently certified by ANCC. The ANCC Magnet Recognition Program® recognizes healthcare organizations that provide the very best in nursing care and professionalism in nursing practice. The program also provides a vehicle for disseminating best practices and strategies among nursing systems. The ANCC Magnet Recognition Program is the gold standard for nursing excellence. The Pathway to Excellence® Program recognizes the essential elements of an optimal nursing practice environment. The designation is earned by healthcare organizations that create work environments where nurses can flourish. The award substantiates the professional satisfaction of nurses and identifies best places to work.



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*Continuing Nursing Education (CNE).* State nurse practice laws are usually the source of authority for establishing the state board of nursing requirements. The state board of nursing establishes the state's CNE requirements for professional nurses. CNE credits are provided through accredited providers that have been approved by the American Nurses Credentialing Center (ANCC) Commission on Accreditation and/or the state board of nursing. CNE requirements vary widely from state to state. Thirty-two states require registered nurses to certify that they have accumulated a minimum number of CNE credits in order to maintain their licenses. In some states, the CNE requirement only applies to re-licensure of advance practice nurses, or additional CNEs may be required of this category of nurses. Required CNE ranges from 12 to 50 credits annually, with reporting generally on a bi-annual basis. Board certifications (e.g., CNOR – certification of perioperative nursing) also require CNE credits, with certain percentages required in specific categories based on the certification type. We are an accredited provider of CNE by the ANCC.

*Continuing Medical Education (CME).* State licensing boards, professional organizations and employers require physicians to certify that they have accumulated a minimum number of continuing medical education hours to maintain their licenses. Generally, each state's medical practice laws authorize the state's board of medicine to establish and track CME requirements. Forty-eight state medical licensing boards currently have CME requirements, as well as Puerto Rico, Guam, and the U.S. Virgin Islands. The number of CME hours required by each state ranges from 12 to 50 hours per year. Other sources of CME requirements are state medical societies and practice specialty boards. The failure to obtain the requisite amount and type of CME could result in non-renewal of the physician's license to practice medicine and/or membership in a medical or practice specialty society. The American Medical Association's (AMA) Physician Recognition Award certificate (PRA) is widely accepted as proof of participation in CME. The AMA classifies continuing medical education activities as either Category 1, which includes formal CME activities, or Category 2, which includes most informal activities. Sponsors want to designate CME activities for *AMA PRA Category 1 Credit* because this has become the benchmark for quality in formally organized educational activities. Most agencies nationwide that require CME participation specify *AMA PRA Category 1 Credit*. Only institutions and organizations accredited to provide CME can designate an activity for *AMA PRA Category 1 Credit*. The Accreditation Council for Continuing Medical Education (ACCME) is responsible for awarding accreditation status to state medical societies, medical schools, and other institutions and organizations that provide CME activities for a national audience of physicians. Only institutions and organizations are accredited. The ACCME and state medical societies do not accredit or approve individual activities. State medical societies, operating under the aegis of the ACCME, accredit institutions and organizations that provide CME activities primarily for physicians within the state or bordering states. We are an accredited provider of CME by the ACCME.

*Centers for Medicare & Medicaid Services (CMS).* CMS has articulated a vision for health care quality *the right care for every person every time*. To achieve this vision, CMS is committed to care that is safe, effective, timely, patient-centered, efficient, and equitable. Medicare's current payment systems reward quantity, rather than quality of care, and provide neither incentive nor support to improve quality of care. Value-based purchasing (VBP), which links payment more directly to the quality of care provided, is a strategy that can help to transform the current payment system by rewarding providers for delivering high quality, efficient clinical care. Through a number of public reporting programs, demonstration projects, pilot programs, and voluntary efforts, CMS has launched VBP initiatives in hospitals, physician offices, nursing homes, home health services, and dialysis facilities.

*Consumer Assessment of Healthcare Providers and Systems (CAHPS).* CMS has partnered with AHRQ to develop a standardized survey instrument and data collection methodology for measuring patients' perspectives on hospital care. The intent of the survey is to produce comparable data on the patients' perspectives to allow consumer-based comparisons between hospitals, align incentives to drive hospitals to improve their quality of care, and increase the transparency of hospital reporting. Hospitals must submit data for certain required quality measures which for inpatients includes the CAHPS® Hospital Survey in order to receive the full market basket increase to their reimbursement payment rates from CMS. While hospital participation is voluntary, hospitals that fail to submit this survey data will incur a reduction of two percentage points in the inpatient market basket update amount for the following federal fiscal year. We have received certified vendor designation and will continue to offer CAHPS® Hospital Survey services. In addition, we are a certified vendor approved to offer CAHPS® Home Health Care Survey

used to measure the experiences of people receiving home health care from Medicare-certified home health agencies. *Medicare and Medicaid EHR Incentive Programs.* The Medicare and Medicaid EHR Incentive Programs will provide incentive payments to eligible professionals, eligible hospitals and critical access hospitals (CAHs) as they adopt, implement, upgrade or demonstrate meaningful use of certified EHR technology. The Medicare and Medicaid EHR Incentive Programs provide a financial incentive for the meaningful use of certified EHR technology to achieve health and efficiency goals. By putting into action and meaningfully using an EHR system, providers will reap benefits beyond financial incentives such as reduction in errors, availability of records and data, reminders and alerts, clinical decision support, and e-prescribing/refill automation.

*Allied Disciplines.* Various allied health professionals are required to obtain continuing education to maintain their licenses. For example, emergency medical services personnel may be required to acquire up to 20 continuing education hours per year, all or a portion of which can be fulfilled online. These requirements vary by state and depend on the classification of the employee.

*Other Continuing Education.* We are also an accredited provider of continuing education and continuing pharmacy education by the Association of Surgical Technologists, Inc. (AST) and the Accreditation Council for Pharmacy Education (ACPE), respectively.

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### **Regulation of Educational Program Sponsorship and Support**

The Office of Inspector General (OIG) issued Compliance Program Guidance for Pharmaceutical Manufacturers in April 2003 and issued Compliance Program Guidance for the Durable Medical Equipment, Prosthetics, Orthotics, and Supply Industry in July 1999 (collectively, the Guidelines). These documents include guidelines related to continuing educational activities supported by pharmaceutical and medical device companies. The Guidelines already have and may continue to affect the type and extent of commercial support we receive for our continuing education activities. The trade associations for the pharmaceutical and medical device industries (PhRMA and AdvaMed, respectively) have also promulgated their own codes of ethics. In January 2009, the PhRMA code of ethics was updated, and AdvaMed made changes to its code of ethics that became effective in July 2009. These changes placed further restrictions on the interactions between industry and health care professionals. The AMA has established its own code of ethics regarding Gifts to Physicians from Industry to provide standards of conduct for the medical profession. The Company follows the rules and guidelines provided by ACCME, ANCC, and other continuing education accrediting bodies to ensure that its continuing education programming is free from commercial bias and consistent with the Guidelines.

In March 2010, the Patient Protection and Affordable Care Act, as amended by the Health Care and Education Reconciliation Act of 2010 (collectively, ACA) became law. ACA requires manufacturers of drugs and devices to annually report to the Department of Health and Human Services anything of value, including educational programs, given by such manufacturers to physicians beginning March 31, 2013. It is difficult to predict the impact of this provision of ACA on us due to lack of implementing regulations or interpretive guidance, gradual and potentially delayed implementation of the requirement, and, pending court challenges and possible amendment or repeal of the law.

### **The U.S. Food and Drug Administration (FDA) and the Federal Trade Commission (FTC)**

Current FDA and FTC rules and enforcement actions and regulatory policies or those that the FDA or the FTC may develop in the future could have a material adverse effect on our ability to provide existing or future applications or services to our end users or obtain the necessary corporate sponsorship to do so. The FDA and the FTC regulate the form, content and dissemination of labeling, advertising and promotional materials, including direct-to-consumer prescription drug and medical device advertising, prepared by, or for, pharmaceutical, biotechnology or medical device companies. The FTC regulates over-the-counter drug advertising and, in some cases, medical device advertising. Generally, regulated companies must limit their advertising and promotional materials to discussions of the FDA-approved claims and, in limited circumstances, to a limited number of claims not approved by the FDA. Therefore, any information that promotes the use of pharmaceutical or medical device products that is presented with our services is subject to the full array of the FDA and FTC requirements and enforcement actions. We believe that banner advertisements, sponsorship links and any educational programs that lack independent editorial control that we may present with our services could be subject to FDA or FTC regulation. While the FDA and the FTC place the principal burden of compliance with advertising and promotional regulations on the advertiser, if the FDA or FTC finds that any regulated information presented with our services violates FDA or FTC regulations, they may take regulatory action against us or the advertiser or sponsor of that information. In addition, the FDA may adopt new regulatory policies that more tightly regulate the format and content of promotional information on the Internet.

### **Other Government Regulations**

It is likely that we will be required to comply with Section 404(b) of the Sarbanes-Oxley Act in the calendar year 2011.

### **INTELLECTUAL PROPERTY AND OTHER PROPRIETARY RIGHTS**

To protect our proprietary rights, we rely generally on copyright, trademark and trade secret laws, confidentiality agreements and procedures with employees, consultants and other third parties, license agreements with consultants, vendors and customers, and control access to our software, documentation and other proprietary information. We own Federal trademark and service mark registrations for the marks HEALTHSTREAM , HOSPITAL DIRECT , OR PROTOCOL , INSIGHT INTO ACTION , and QUALITY CHECK. We have also obtained registration of the HEALTHSTREAM mark in certain other countries. Applications for several trademarks are currently pending, however, there can be no assurance that we will be successful in obtaining registration of other trademarks for which

we have applied.

The courseware that we license to our customers is developed through a combination of license agreements with publishers or authors, assignments and work-for-hire arrangements with third parties, and development by employees. We require publishers, authors and other third parties to represent and warrant that their content does not infringe on or misappropriate any third-party intellectual property rights and that they have the right to provide their content and have obtained all third-party consents necessary to do so. Our publishers, authors and other third parties also agree to indemnify us against certain liability we might sustain due to the content they provide.

If a third party asserts a claim that we have infringed its patents or other intellectual property, we may be required to redesign our products or enter into royalty or licensing agreements. In addition, we license technologies from third parties for incorporation into our services. Royalty and licensing agreements with these third parties may not be available on terms acceptable to us, if at all. Additionally, the steps we have taken to protect our intellectual property and proprietary rights may not be adequate. Third parties may infringe or misappropriate our intellectual property. Competitors may also independently develop technologies that are substantially equivalent or superior to the technologies we employ in our products or services. If we fail to protect our proprietary rights adequately, our competitors could offer similar services, potentially significantly harming our competitive position and decreasing our revenues.

**Table of Contents****AVAILABLE INFORMATION**

The Company files reports with the SEC, including annual reports on Form 10-K, quarterly reports on Form 10-Q and other reports from time to time. The public may read and copy any materials we file with the SEC at the SEC's Public Reference Room at 100 F Street, NE, Washington, DC 20549. The public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The Company is an electronic filer and the SEC maintains an Internet site at <http://www.sec.gov> that contains the reports, proxy and information statements, and other information filed electronically. Our website address is [www.healthstream.com](http://www.healthstream.com). Please note that our website address is provided as an inactive textual reference only. We make available free of charge through our website, the annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports as soon as reasonably practicable after such material is electronically filed with or furnished to the SEC. The information provided on our website is not part of this report, and is therefore not incorporated by reference unless such information is otherwise specifically referenced elsewhere in this report.

**OUR EMPLOYEES**

As of December 31, 2010, we employed 356 full-time and 76 part-time persons, including approximately 127 employees in our interviewing center. Our success will depend in large part upon our ability to attract and retain qualified employees. We face competition in this regard from other companies, but we believe that we maintain good relations with our employees. We are not subject to any collective bargaining agreements.

**EXECUTIVE OFFICERS OF THE REGISTRANT**

The following is a brief summary of the business experience of each of the executive officers of the Company. Officers of the Company are elected by the Board of Directors and serve at the pleasure of the Board of Directors. The following table sets forth certain information regarding the executive officers of the Company:

<b>Name</b>	<b>Age</b>	<b>Position</b>
Robert A. Frist, Jr.	43	Chief Executive Officer, President and Chairman of the Board of Directors
Jeffrey S. Doster	46	Senior Vice President and Chief Technology Officer
Gerard M. Hayden, Jr.	56	Senior Vice President and Chief Financial Officer
Arthur E. Newman	62	Executive Vice President
J. Edward Pearson	48	Senior Vice President and President of HealthStream Research
Kevin P. O Hara	41	Senior Vice President, General Counsel, and Compliance Officer
Michael Sousa	42	Senior Vice President

Robert A. Frist, Jr., one of our co-founders, has served as our chief executive officer and chairman of the board of directors since 1990 and president since 2001. Mr. Frist is the company's chief operating decision maker, and has primary responsibility and oversight of HealthStream Learning. He graduated with a Bachelor of Science in business with concentrations in finance, economics and marketing from Trinity University.

Jeffrey S. Doster joined the Company in May 2008 as senior vice president and chief technology officer. From November 2006 to May 2008, he served as principal at The Altus Group LLC, a business consulting company. From March 2005 to October 2006, he served as senior vice president and chief technology officer at The Shop at Home Network, LLC, a television shopping company. From October 2000 to April 2004, he served as senior vice president of information technology at New Roads, Inc., a provider of fulfillment and other services to retailers. He earned undergraduate degrees in both Economics and Business Administration from Towson University, as well as a Master of Business Administration from Loyola College, in Maryland.

Gerard M. Hayden, Jr. joined the Company as senior vice president and chief financial officer in May 2008. From April 2007 to May 2008, he served as executive vice president and chief financial officer of MedAvant Healthcare Solutions, a healthcare transaction processing company. From January 2005 to April 2007, he was a consultant for various healthcare, technology and other business ventures. From November 2001 to January 2005, he served as chief financial officer for Private Business, Inc., a company offering marketing and software solutions to regional and community banks in the United States. He earned a Bachelor of Arts from the University of Notre Dame and a Master of Science from Northeastern University. Mr. Hayden served on the Company's Board of Directors and was a member of the Audit Committee from September 2006 to May 2008.

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Arthur E. Newman joined the Company in January 2000, and is currently our Executive Vice President. Previously he served as our chief financial officer and senior vice president from January 2000 to March 2006. He holds a Bachelor of Science in chemistry from the University of Miami and a Master of Business Administration from Rutgers University.

J. Edward Pearson joined the company in June 2006 as senior vice president, responsible for our survey and research business and was named president of HealthStream Research during 2007. From June 2003 to June 2006, he served as president and chief executive officer of DigiScript, an Internet-based training and communication solutions provider for the life sciences industry. He earned a Bachelor of Business Administration in accounting from Middle Tennessee State University.

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Kevin P. O Hara joined the company in January 2002, and was promoted to senior vice president and general counsel in February 2007. He assumed compliance officer responsibilities during August 2007. He previously served as vice president for the company. He earned a Bachelor of Arts degree and a J.D. from Vanderbilt University.

Michael Sousa joined the company in October 2004, and was promoted to senior vice president in January 2010. He previously served as vice president for the Company, with responsibilities for our strategic accounts program within HealthStream Learning. He earned a Bachelor of Science degree from Boston College and a Master of Business Administration from Boston University.

**Item 1A. Risk Factors**

We believe that the risks and uncertainties described below and elsewhere in this document are the principal material risks facing the Company as of the date of this report. In the future, we may become subject to additional risks that are not currently known to us. Our business, financial condition or results of operations could be materially adversely affected by any of the following risks and by any unknown risks. The trading price of our common stock could decline due to any of the following risks or any unknown risks.

**Risks Related to Our Business Model**

***We may be unable to effectively execute our growth strategy which could have an adverse effect on our business and competitive position in the industry.***

Our business strategy includes increasing our market share and presence through sales to new customers, additional sales to existing customers, introductions of new products and services, and maintaining strong relationships with our existing customers. Some of the risks that we may encounter in executing our growth strategy include:

expenses, delays and difficulties of identifying and developing new products or services and integrating such new products or services into our existing organization;

inability to leverage our operational and financial systems sufficiently to support our growth;

inability to generate sufficient revenue from new products to offset investment costs;

inability to effectively identify, manage and exploit existing and emerging market opportunities;

inability to maintain our existing customer relationships;

increased competition from new and existing competitors;

lengthy sales cycles, or customers delaying purchasing decisions due to economic conditions;

reduced spending within the training, information and education departments of hospitals within our target market; and

failure of the market for training, information and education in the healthcare industry to grow to a sufficient size or at a sufficient rate.

If any of these risks are realized, our business, and our competitive position in the industry, could suffer.

***We may be unable to effectively identify, complete or integrate the operations of future acquisitions, joint ventures or other growth investments.***

As part of our growth strategy, we actively review possible acquisitions, joint ventures or growth investments that complement or enhance our business. We may not be able to identify, complete or integrate the operations of future acquisitions, joint ventures or other growth investments. In addition, if we finance acquisitions, joint ventures or other growth initiatives by issuing equity securities, our existing shareholders may be diluted which could affect the market price of our stock. As a result, if we fail to properly evaluate and execute acquisitions and investments, our business prospects may be seriously harmed. Some of the risks that we may encounter in implementing our acquisition, joint venture or growth investment strategies include:

expenses, delays or difficulties in identifying and integrating acquired companies or joint venture operations or other growth investments into our organization;

inability to retain personnel associated with acquisitions, joint ventures, or other growth investments;

diversion of management's attention from other initiatives to effectively execute our growth strategy; and

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



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

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

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

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

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

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

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

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

We can not guarantee that we will be able to strengthen our relationships with strategic partners or that such relationships will be successful in generating additional revenue. If any of these strategic partners are unsuccessful in their involvement with our products and services, or seek to amend the financial or other terms of the contracts we have with them, we will need to broaden our efforts to increase focus on the solutions they sell and alter our

development, integration, and/or distribution strategies, which may divert our planned efforts and resources from other projects.

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

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

Most of our agreements with content providers are for initial terms of two to three years. The content partners may choose not to renew their agreements with us or may terminate the agreements early if we do not fulfill our contractual obligations. If a significant number of our content providers terminate or fail to renew their agreements with us on acceptable terms, it could result in a reduction in the number of courses we are able to distribute, causing decreased revenues. Most of our agreements with our content partners are non-exclusive, and our competitors offer, or could offer, training and continuing education content that is similar to or the same as

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ours. If publishers and authors, including our current content partners, offer information to users or our competitors on more favorable terms than those offered to us, or increase our license fees, our competitive position and our profit margins and prospects could be harmed. In addition, the failure by our content partners to deliver high-quality content and to revise their content in response to user demand and evolving healthcare advances and trends could result in customer dissatisfaction and inhibit our ability to attract and retain subscribers of our courseware offerings.

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

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

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

We use licensed third party technology components in some of our products. Future licenses to this technology may not be available to us on commercially reasonable terms, or at all. The loss of or inability to obtain or maintain any of these licenses could result in delays in the introduction of new products and services or could force us to discontinue offering portions of our learning management or survey and research solutions until equivalent technology, if available, is identified, licensed and integrated. The operation of our products would be impaired if errors occur in the third party technology or content that we incorporate, and we may incur additional costs to repair or replace the defective software. It may be difficult for us to correct any errors in third party software because the software is not within our control. Accordingly, our revenue could decrease and our costs could increase in the event of any errors in this technology. Furthermore, we may become subject to legal claims related to licensed technology based on product liability, infringement of intellectual property or other legal theories.

**Financial Risks**

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

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

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

For the year ended December 31, 2010, approximately 65 percent of our net revenue was derived from our Internet-based subscription products. Our Internet-based HLC customers have no obligation to renew their subscriptions for our products or services after the expiration of the subscription agreement, and in fact, some customers have elected not to renew their subscription. In addition, our customers may renew at a lower pricing or

activity level. During the year ended December 31, 2010, we renewed 101% of the annual HLC contract value up for renewal and 100% of the subscribers which were up for renewal. Because a significant portion of our customer contracts have only renewed three or fewer times, we do not have sufficient historical data to accurately predict future customer renewal rates. Our customers' renewal rates may decline or fluctuate as a result of a number of factors, including but not limited to their dissatisfaction with our service, pricing or competitive product offerings. If we are unable to renew a substantial portion of the contracts that are up for renewal or maintain our pricing, our revenue could be adversely affected, which would have a material adverse effect on our results of operations and financial position. HealthStream Research product and service contracts typically range from one to three years in length, and customers are not obligated to renew their contract with us after their contract expires. Because Research customers have only renewed three or fewer times we do not have sufficient historical data to accurately predict customer renewal rates. If our customers do not renew their arrangements for our services, or if their activity levels decline, our revenue may decline and our business will suffer.

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

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

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

We recognize approximately 65 percent of our revenue from customers monthly over the terms of their subscription agreements, which have initial contract terms ranging from one to three years, although terms can range from less than one to up to five years. As a result, much of the revenue we report in each quarter is related to subscription agreements entered into during previous quarters. Consequently, a decline in new or renewed subscription agreements in any one quarter will not necessarily be fully reflected in the revenue in that quarter and will negatively affect our revenue in future quarters. In addition, we may be unable to adjust our cost structure to reflect this reduced revenue. Accordingly, the effect of significant downturns in sales and market acceptance of our products and services may not be fully reflected in our results of operations until future periods. Additionally, our subscription model also makes it difficult for us to rapidly increase our revenue through additional sales in any period, as revenue from new customers must be recognized over the applicable subscription term. Finally, the majority of costs associated with sales are incurred up front, and therefore unexpected successes in platform and courseware sales may increase our costs in the near term negatively affecting our financial performance.

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

We expect our current cash reserves, revolving credit facility, and results of operations to be sufficient to meet our cash requirements through at least 2011. However, we may need to raise additional funds in order to:

develop new, or enhance existing, services or products;

respond to competitive pressures;

finance working capital requirements;

acquire complementary businesses, technology, content or products, or

otherwise effectively execute our growth strategy.

At December 31, 2010, we had approximately \$23.6 million in unrestricted cash, cash equivalents, investments in marketable securities and related interest receivable. We also have up to \$15.0 million of availability under a revolving credit facility, subject to certain covenants, which expires in July 2011. We expect to incur approximately \$6.0 million of capital expenditures, software feature enhancements and content purchases during 2011 to support our business. We continue to actively review possible business acquisitions that would complement or enhance our products and services. We may not have adequate cash and investments or availability under our revolving credit facility to consummate one or more of these acquisitions. The capital markets have been experiencing extreme volatility and disruption, and we cannot assure you that if we need additional financing that it will be available on terms favorable to us, or at all. If adequate funds are not available or are not available on acceptable terms, our ability to fund expansion, take advantage of available opportunities, develop or enhance services or products or otherwise respond to competitive pressures would be significantly limited. If we raise additional funds by issuing equity or convertible debt securities, the percentage ownership of our existing shareholders may be reduced.

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

As of December 31, 2010, our balance sheet included goodwill of \$21.1 million and identifiable intangible assets of \$2.8 million. Economic, legal, regulatory, competitive, contractual, and other factors could result in future declines in the operating results of our business units or market value declines that do not support the carrying value of goodwill and identifiable intangible assets. If any of these factors impair the value of these assets, accounting rules require us to reduce their carrying value and report an impairment charge, which would reduce our reported assets and earnings for the period in which an impairment is recognized.

***Our stock price is likely to be volatile.***

The market price of our common stock is likely to be volatile and could be subject to significant fluctuations in response to factors such as the following, many of which are beyond our control: quarterly variations in our operating results; operating results that vary from the expectations of securities analysts and investors; changes in expectations regarding our future financial performance; changes in market valuations of other online service companies; future sales of our common stock; stock market price and volume

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fluctuations; general political and economic conditions, such as a recession or war or terrorist attacks or interest rate or currency rate fluctuations; and other risk factors described in this Annual Report on Form 10-K. Moreover, our stock is thinly traded, and we have a relatively small public float. These factors may adversely affect the market price of our common stock. In addition, the market prices for stocks of many Internet related and technology companies have historically experienced significant price fluctuations that in some cases appear to bear no relationship to the operating performance of these companies.

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

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

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

Sarbanes-Oxley Section 404 requires our management to report on, and may require our independent public accounting firm to attest to, the effectiveness of our internal controls over financial reporting. It is likely that we will be required to comply with the reporting requirements under Sarbanes-Oxley Section 404(b) in the 2011 calendar year since the Company's public float currently exceeds the \$75 million threshold for becoming an accelerated filer. The rules governing the standards to be met are complex and will require significant process review, documentation and testing, as well as possible remediation efforts for any identified deficiencies. This process of review, documentation, testing and remediation will result in increased expenses and require significant attention from management and other internal and external resources. Any material weaknesses identified during this process may preclude us from asserting the effectiveness of our internal controls. This may negatively affect our stock price if we cannot effectively remediate the issues identified in a timely manner.

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

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

#### **Risks Related to Sales, Marketing and Competition**

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

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

**Risks Related to Operations**

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

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



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

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

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

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

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

We must continue to obtain reasonably priced, commercially available hardware and operating software as well as continue to enhance our software to accommodate the increased use of our platform and increased courseware in our library. In order to make timely decisions about hardware and software enhancements, we must be able to accurately forecast the growth in demand for our services. This growth in demand for our services is difficult to forecast and the potential audience for our services is large. If we are unable to increase the data storage and processing capacity of our systems at least as fast as the growth in demand, our customers may encounter delays or disruptions in their service. Unscheduled downtime could harm our business and also could discourage current and potential customers from using or continuing to use our services and reduce future revenue.

***Our network infrastructure and computer systems and software may fail.***

An unexpected event including but not limited to a telecommunications failure, fire, earthquake, or other catastrophic loss at our Internet service providers facilities or at our on-site data facility could cause the loss of critical data and prevent us from offering our products and services for an unknown period of time. Our business interruption insurance may not adequately compensate us for losses that may occur. In addition, we rely on third parties to securely store our archived data, house our web server and network systems and connect us to the Internet. While our service providers have planned for certain contingencies, the failure by any of these third parties to provide these services satisfactorily and our inability to find suitable replacements would impair our ability to access archives and operate our systems and software.

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

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

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

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

**Table of Contents****Risks Related to Government Regulation, Content and Intellectual Property*****Government regulation may require us to change the way we do business.***

The laws and regulations that govern our business change rapidly. Evolving areas of law that are relevant to our business include privacy and security laws, proposed encryption laws, content regulation, information security accountability regulation, and sales and use tax laws and regulations and attempts to regulate activities on the Internet. Because of this rapidly evolving and uncertain regulatory environment, we cannot predict how these laws and regulations might affect our business. These uncertainties make it difficult to ensure compliance with the laws and regulations governing or impacting our business. These laws and regulations could harm us by subjecting us to liability or forcing us to change how we do business. In addition, certain laws mandate that our customers contractually require us to protect the privacy and security of certain personal and health related information. If we fail to abide by these required contractual provisions, our customers may terminate their contracts with us. In addition, ARRA recently expanded the application of certain of the HIPAA privacy and security regulations to apply directly to business associates including us. Violations of HIPAA privacy and security regulations may result in civil and criminal penalties. Further, ARRA has increased these penalties and strengthened other enforcement provisions of HIPAA, which may result in increased enforcement activity. See *Business Government Regulation of the Internet and the Healthcare Industry* for a more complete discussion of these laws and regulations.

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

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

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

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

***Changes to government and industry standards and regulations regarding pharmaceutical and medical device customers could negatively affect our business in these areas.***

In April 2003, the OIG issued *OIG Compliance Program Guidance for Pharmaceutical Manufacturers*. In July 1999, the OIG issued *Compliance Program Guidance for the Durable Medical Equipment, Prosthetics, Orthotics and Supply Industry*. These guidelines collectively identify three areas of risks for pharmaceutical and medical device companies and recommend certain best practices to be included in a compliance plan designed to avoid the risk of federal healthcare program abuse. The guidance highlighted a number of arrangements that have the potential to trigger fraud and abuse violations, including educational grants. In April 2007, the U.S. Senate Finance Committee released a report critical of practices related to the funding of educational programs by pharmaceutical manufacturers. In March 2010, ACA became law. As enacted, ACA will change how health care services are covered, delivered, and reimbursed. ACA includes requirement that manufacturers of drugs and medical devices to annually report to HHS anything of value, including educational programs given by such manufacturers to physicians, beginning March 31, 2013. It is unclear how this requirement may change the behavior of our pharmaceutical and medical device customers, but should our customers choose to discontinue providing such education programs to physicians, our business may be negatively impacted. ACA is currently subject to a number of court challenges and appeals. It is unclear how they will be resolved. Further, Congress is considering bills that would repeal or revise ACA.

The Company follows the rules and guidelines provided by the ACCME, ANCC and other continuing education accrediting bodies to ensure that its continuing education programming is free from commercial bias and consistent with the OIG guidance. The 2009 changes to the codes of ethics of the pharmaceutical and medical device trade associations place further restrictions on interactions between pharmaceutical and medical device manufacturers and health care professionals. The majority of the Company's accredited continuing education programming is funded by educational grants from our pharmaceutical and medical device customers. There is no assurance that our pharmaceutical and medical device customers will continue to provide educational grants consistent with past practices. In fact, we have experienced a reduction in live event activities we provide that are supported by pharmaceutical and medical device companies. To the extent that our customers continue to curtail or restructure their business practices, our business with this customer base may suffer.

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

We may be liable to third parties for the content in our online library if the text, graphics, software or other content in our library violates copyright, trademark, or other intellectual property rights, our content partners violate their contractual obligations to others by providing content to our library, or the content does not conform to accepted standards of care in the healthcare profession. We attempt to minimize these types of liabilities by requiring representations and warranties relating to our content partners' ownership of

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the rights to distribute as well as the accuracy of their content. We also take necessary measures to review this content ourselves. Although our agreements with our content partners contain provisions providing for indemnification by the content providers in the event of inaccurate content, our content partners may not have the financial resources to meet this obligation. Alleged liability could harm our business by damaging our reputation, requiring us to incur legal costs in defense, exposing us to awards of damages and costs, and diverting management's attention away from our business. See *Business - Intellectual Property and Other Proprietary Rights* for a more complete discussion of the potential effects of this liability on our business.

***Protection of certain intellectual property may be difficult and costly.***

Despite protection of certain proprietary rights, a third-party could, without authorization, copy or otherwise misappropriate our content, information from our databases, or other intellectual property. Our agreements with employees, consultants and others who participate in development activities could be breached and result in our trade secrets becoming known, or our trade secrets and other intellectual property could be independently developed by competitors. We may not have adequate remedies for any breach. In addition, the laws of some foreign countries do not protect our proprietary rights to the same extent as the laws of the United States, and effective intellectual property protection may not be available in those jurisdictions. We currently own several trademarks and domain names. The current system for registering, allocating and managing domain names has been the subject of litigation and proposed regulatory reform. Additionally, legislative proposals have been made by the federal government that would afford broad protection to owners of databases of information, such as stock quotes. This protection of databases already exists in the European Union. There has been substantial litigation in the computer and online industries regarding intellectual property assets, particularly patents. Third parties may claim infringement by us with respect to current and future products, trademarks or other proprietary rights, and we may counterclaim against such third parties in such actions. Any such claims or counterclaims could be time-consuming, result in costly litigation, divert management's attention, cause product release delays, require us to redesign our products or require us to enter into royalty or licensing agreements, any of which could have a material adverse effect upon our business, financial condition and operating results. Such royalty and licensing agreements may not be available on terms acceptable to us, if at all.

***We may be unable to protect our intellectual property, and we may be liable for infringing the intellectual property rights of others.***

Our business could be harmed if unauthorized parties infringe upon or misappropriate our intellectual property, proprietary systems, content, platform, services or other information. Our efforts to protect our intellectual property through copyright, trademarks and other controls may not be adequate. In the future, litigation may be necessary to enforce our intellectual property rights or to determine the validity and scope of the patents, intellectual property or other proprietary rights of third parties, which could be time consuming and costly. Intellectual property infringement claims could be made against us, especially as the number of our competitors grows. These claims, even if not meritorious, could be expensive and divert our attention from operating our company and result in a temporary inability to use the intellectual property subject to such claim. In addition, if we become liable to third parties for infringing their intellectual property rights, we could be required to pay a substantial damage award and develop comparable non-infringing intellectual property, to obtain a license, or to cease providing the content or services that contain the infringing intellectual property. We may be unable to develop non-infringing intellectual property or obtain a license on commercially reasonable terms, if at all. See *Business-Intellectual Property and Other Proprietary Rights* for a more complete discussion of the potential effects of this liability on our business.

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

None.

***Item 2. Properties***

Our principal office is located in Nashville, Tennessee. Our lease for approximately 50,000 square feet at this location expires in April 2017. The lease provides for a two-year renewal option with rates increasing during the renewal period. Rent at this location is currently approximately \$58,000 per month through April 2012, \$61,000 per month from May 2012 through April 2014, \$62,000 per month from May 2014 through April 2015, and \$65,000 per month from May 2015 through April 2017.

We are leasing approximately 19,000 square feet of office space in Laurel, Maryland. The lease expires in March 2012 and provides for two renewal options for two years each. Rent at this location is approximately \$32,000 per month, with annual rental increases of approximately three percent.

**Item 3. *Legal Proceedings***

None.

**Item 4. *(Removed and Reserved)***

**Table of Contents****PART II****Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.**

The following table sets forth, for the periods indicated, the high and low sales prices per share of our common stock as reported on the NASDAQ Global Market under the ticker symbol HSTM:

	Common Stock Price			
	2010		2009	
	High	Low	High	Low
First Quarter	\$ 4.27	\$ 3.47	\$ 2.40	\$ 1.70
Second Quarter	4.85	4.05	2.74	2.01
Third Quarter	5.32	4.39	5.21	2.56
Fourth Quarter	8.04	5.11	4.65	3.75

On March 4, 2011, there were 125 registered holders and approximately 4,822 beneficial holders of our common stock. Because many of such shares are held by brokers and other institutions on behalf of shareholders, we are unable to estimate the total number of shareholders represented by these record holders.

**DIVIDEND POLICY**

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

**STOCK PERFORMANCE GRAPH**

The graph below compares the cumulative total shareholder return on our common stock since December 31, 2005, with the cumulative total return of companies on the Nasdaq Composite Index and the Nasdaq Computer & Data Processing Index over the same period (assuming the investment of \$100 in our common stock, the Nasdaq Composite Index and the Nasdaq Computer & Data Processing Index on December 31, 2005 (for our stock and the indices) and reinvestment of all dividends).

**COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN <sup>(1)</sup>****Among HealthStream, Inc., The NASDAQ Composite Index  
And The NASDAQ Computer & Data Processing Index**

(1) \$100 invested on 12/31/2005 in stock or index-including reinvestment of dividends. Fiscal year ending December 31.

**Table of Contents****RECENT SALES OF UNREGISTERED SECURITIES**

There have been no sales of unregistered securities since December 31, 2009.

**ISSUER PURCHASES OF EQUITY SECURITIES**

There were no common stock purchases by the Company during the quarter ended December 31, 2010.

**Item 6. Selected Financial Data**

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

HealthStream acquired The Jackson Organization, Research Consultants, Inc. (TJO) on March 12, 2007. TJO's results of operations are included within our consolidated statement of operations effective March 13, 2007. As a result of this acquisition, the annual results presented below are not comparable. Revenues may be subject to fluctuations as discussed further in Management's Discussion and Analysis of Financial Condition and Results of Operations located elsewhere in this report. During 2010, we recorded a tax provision of approximately \$2.9 million. During 2009, 2008, and 2007 we recognized portions of our deferred tax assets through the reversal of the valuation allowance, resulting in deferred income tax benefits of approximately \$9.1 million, \$375,000, and \$2.0 million, respectively. As a result of these factors, the annual results presented below are not comparable. The operating results for any single year are not necessarily indicative of the results to be expected in the future.

	<b>Year Ended December 31,</b>				
	<b>(in thousands, except per share data)</b>				
	<b>2010</b>	<b>2009</b>	<b>2008</b>	<b>2007</b>	<b>2006</b>
<b>STATEMENT OF INCOME DATA:</b>					
Revenues, net	\$ 65,754	\$ 57,398	\$ 51,600	\$ 43,949	\$ 31,783
Operating costs and expenses:					
Cost of revenues (excluding depreciation and amortization)	24,191	21,344	19,654	16,162	10,869
Product development	6,989	6,285	5,670	4,308	3,503
Sales, marketing, general and administrative expenses	22,635	19,508	18,972	17,060	12,613
Depreciation and amortization	4,880	5,139	4,822	4,503	2,889
Total operating costs and expenses	58,695	52,276	49,118	42,033	29,874
Income from operations	7,059	5,122	2,482	1,916	1,909
Other income (expense), net	(21)	(15)	72	226	619
Income before income taxes	7,038	5,107	2,554	2,142	2,528
Income tax provision (benefit)	2,884	(8,865)	(301)	(1,945)	28
Net income	\$ 4,154	\$ 13,972	\$ 2,855	\$ 4,087	\$ 2,500
Net income per share - basic	\$ 0.19	\$ 0.65	\$ 0.13	\$ 0.19	\$ 0.12
Net income per share - diluted	\$ 0.18	\$ 0.64	\$ 0.13	\$ 0.18	\$ 0.11
Weighted average shares of common stock outstanding - basic	21,767	21,458	21,707	21,999	21,577
	22,488	21,838	22,204	22,701	22,359



Weighted average shares of common stock  
outstanding diluted

	2010	2009	At December 31, 2008		2007	2006
			(in thousands)			
<b>BALANCE SHEET DATA:</b>						
Cash and cash equivalents	\$ 17,868	\$ 12,287	\$ 4,107		\$ 3,599	\$ 10,726
Investments in marketable securities short term	5,703					1,700
Goodwill and intangible assets	23,991	24,938	25,885		26,851	13,073
Working capital (deficit)	19,524	10,714	1,148		(906)	11,148
Total assets	82,011	71,002	52,797		53,361	41,008
Deferred revenue	16,740	12,234	10,202		9,493	5,376
Long-term debt and capital leases, net of current portion		4	320		1,064	107
Shareholders' equity	56,790	51,821	36,763		35,714	29,634

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

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

The following discussion provides an overview of our history together with a summary of our critical accounting policies and estimates. Our critical accounting policies and estimates include revenue recognition, income taxes, product development costs and related capitalization, impairment of goodwill, intangibles and other long-lived assets, allowance for doubtful accounts, accrual for service credits, stock based compensation, and nonmonetary exchanges.

**OVERVIEW**

We provide our services to healthcare organizations, pharmaceutical and medical device companies, and other participants within the healthcare industry. Our services are primarily focused on the delivery of education and training products and services (HealthStream Learning), as well as survey and research services (HealthStream Research). HealthStream Learning products and services include our Internet-based HealthStream Learning Center®, authoring tools, courseware subscriptions, online training and content development, online sales training courses, live events, HospitalDirect® and other products focused on education and training to serve professionals that work within healthcare organizations. HealthStream Research provides a wide range of quality and satisfaction surveys, data analyses of survey results, and other research-based measurement tools focused on patients, employees, physicians, and members of the community. Our learning solutions help healthcare organizations improve their required regulatory training, while also offering an opportunity to train their employees in multiple clinical areas. Our research products provide customers valuable insight into measuring quality and satisfaction of physicians, patients, employees, and members of the community.

Revenues for the year ended December 31, 2010 were approximately \$65.8 million compared to \$57.4 million for the year ended December 31, 2009, an increase of 14.6%. Operating income increased by 37.8% to \$7.1 million for 2010 compared to \$5.1 million for 2009. Net income was approximately \$4.2 million for 2010, compared to \$14.0 million for 2009. Net income per diluted share was \$0.18 per share for 2010 compared to \$0.64 per diluted share for 2009.

Net income for 2010 includes an income tax provision of \$2.9 million, or \$0.13 per diluted share, while net income for 2009 included an income tax benefit of \$8.9 million, or \$0.41 per diluted share. Revenues from HealthStream Learning grew by 18.4%, or \$7.0 million, and revenues from HealthStream Research grew by 7.0%, or \$1.3 million. We had approximately 2,450,000 contracted subscribers, of which approximately 2,250,000 were fully implemented subscribers on our Internet-based HLC platform at December 31, 2010, representing over 2,500 hospitals in the United States. During 2010, we renewed approximately 900,000 HLC subscribers, representing a 100% renewal rate for the subscribers up for renewal, and a 101% renewal rate based on the annual contract value up for renewal. As of December 31, 2010 our cash and investment balances approximated \$23.6 million, and we maintained full availability under our \$15.0 million revolving credit facility.

**CRITICAL ACCOUNTING POLICIES AND ESTIMATES****Revenue Recognition**

We recognize revenues from our Internet-based learning products and courseware subscriptions based on a per person subscription basis, and in some cases on a per license basis. Our fees are based on the size of the facilities or organizations' employee user population and the service offerings to which they subscribe. Revenue is recognized ratably over the service period of the underlying contract. Revenues associated with online training are recognized over the term of the subscription period or over the historical usage period, if usage typically differs from the subscription period. All other service revenues are recognized as the related services are performed or products are delivered.

Revenues from survey and research services are recognized when survey results are delivered to customers via either Internet-based reporting throughout the survey period or by providing final survey results once all services are complete. A significant portion of revenues for survey and reporting services that are provided through the use of

Internet-based reporting methodologies are recognized using the proportional performance method, reflecting recognition throughout the service period which corresponds with the survey cycle and reporting access by the customer, which typically ranges from one to five months. If survey results are delivered to the customer after all services have been completed, then the corresponding revenues are recognized in full in the period such results are provided to the customer. All other revenues are recognized as the related services are performed or products are delivered to the customer. Revenues for these services can be subject to seasonal factors based on customers requirements that can impact the timing, frequency, and volume of survey cycles.

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

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

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Revenues from content maintenance and development services are recognized using a percentage of completion method based on labor hours, which correspond to the completion of performance milestones and deliverables. Sales of products and services to pharmaceutical and medical device companies can be subject to seasonal factors as a result of meeting and conference dates for such companies.

We expect to continue to generate revenues by marketing our Internet-based products and our survey and research services through healthcare organizations and to a lesser extent, through pharmaceutical and medical device companies. We expect that the portion of our revenues related to services provided via our Internet-based learning products will increase in absolute dollar amounts. Specifically, we will seek to generate revenues from healthcare workers by marketing to their employers or sponsoring organizations. The fees we charge for courseware resulting from this marketing is typically paid by either the employer or sponsoring organization.

**Accounting for Income Taxes**

The Company accounts for income taxes using the asset and liability method, whereby deferred tax assets and liabilities are determined based on the temporary differences between the financial statement and tax bases of assets and liabilities measured at tax rates that will be in effect for the year in which the differences are expected to affect taxable income. The Company has significant net operating loss carryforwards (NOLs) which management believes will be available to reduce future tax expense. These NOLs are subject to annual limitations under the Internal Revenue Code Section 382, which could result in the expiration of certain portions of the Company's NOLs before they are fully utilized. Management periodically assesses the realizability of its deferred tax assets, and to the extent that we believe a recovery is not likely, we establish a valuation allowance to reduce the deferred tax asset to the amount we estimate will be recoverable. At December 31, 2009, management concluded that it was more likely than not that substantially all of the remaining deferred tax assets will be realized in future periods, and released approximately \$9.1 million from the valuation allowance. The Company continues to maintain a valuation allowance of approximately \$1.1 million for the remaining portion of its deferred tax assets, which are related to the portion of our NOLs associated with deductions for stock option exercises.

**Product Development Costs**

Product development includes our costs to develop and maintain our products and applications, including our Internet-based learning products and our survey reporting application. Once planning is completed and development begins, we capitalize internal costs and payments to third parties associated with the development efforts where the life expectancy is greater than one year and the anticipated cash flows are expected to exceed the cost of the related asset. During 2010 and 2009, we capitalized approximately \$57,000 and \$84,000, respectively, related to development of content, primarily by third parties. Such amounts are included in the accompanying consolidated balance sheets under the caption prepaid development fees and other assets. During 2010 and 2009, we capitalized approximately \$2.0 million and \$1.3 million, respectively, for the development of various software feature enhancements. Such amounts are included in the accompanying consolidated balance sheets under the caption capitalized software feature enhancements. A significant portion of these capitalized costs was associated with our competency assessment product and additional features for our Internet-based HLC platform. We amortize content and software feature enhancements over their expected life, which is generally one to four years. Capitalized content and software feature enhancements are subject to a periodic impairment review in accordance with our impairment review policy.

In connection with product development, our significant estimates involve the assessment of the development period for new products, as well as the expected useful life of costs associated with new products, software feature enhancements and content. Once capitalized, software feature enhancements and content development costs are subject to the policies and estimates described below regarding goodwill, intangibles and other long-lived assets. Product development costs also include our systems team, which manages our efforts associated with product development and maintenance, database management, quality assurance and security. This team is responsible for new internal product development, integration of external new products, and continued enhancements and regularly scheduled maintenance to our learning and research platform products. Personnel who are responsible for our overall product portfolio as well as prioritization of new product development are also included in product development costs.

**Goodwill, Intangibles and Other Long-lived Assets**

We measure goodwill for impairment at the reporting unit level using both income and market based models to determine the fair value of the reporting units. Our models contain significant assumptions and accounting estimates about discount rates, future cash flows and terminal values that could materially affect our operating results or financial position if they were to change significantly in the future and could result in an impairment. We perform our goodwill impairment test whenever events or changes in facts or circumstances indicate that impairment may exist and also during the fourth quarter each year. Intangible assets and other long-lived assets are also reviewed for events or changes in facts and circumstances, both internally and externally, which may indicate an impairment is present. We measure any impairment using observable market values or discounted future cash flows from the related long-lived assets. The cash flow estimates and discount rates incorporate management's best estimates, using appropriate and customary assumptions and projections at the date of evaluation.

**Allowance for Doubtful Accounts**

We estimate the allowance for doubtful accounts using both a specific and non-specific identification method. Management's evaluation includes reviewing past due accounts on a case-by case basis, and determining whether an account should be reserved, based on the facts and circumstances surrounding each potentially uncollectible account. An allowance is also maintained for accounts not specifically

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identified that may become uncollectible in the future. Uncollectible accounts are written-off in the period management believes it has exhausted every opportunity to collect payment from the customer. Bad debt expense is recorded when events or circumstances indicate an additional allowance is necessary based on our specific and non-specific identification approach. Our allowance for doubtful accounts totaled approximately \$157,000 as of December 31, 2010.

**Accrual for Service Credits**

Due to the complexity of our hosted applications, variability in customer utilization patterns, changes in technology, and potential software defects, our hosted learning management applications could experience periodic downtime. In addition, we have specific contractual obligations that can result in penalties to us associated with system performance and other commitments. We maintain an accrual which is intended to provide for concessions due to customers experiencing inconveniences or operation disruption resulting from downtime or performance of our applications, or our failure to meet certain contractual obligations to customers. Our accrual for service credits totaled approximately \$194,000 as of December 31, 2010.

**Stock Based Compensation**

We recognize compensation expense using a fair-value based method for costs related to share based payments including stock options. Measurement of such compensation expense requires significant estimation and assumptions; however, we believe that the Black Scholes option pricing model we use for calculating the fair value of our stock based compensation plans provides a reasonable measurement methodology using a framework that is widely adopted. As of December 31, 2010, we had a stock incentive plan which qualified as a stock based compensation plan. During the years ended December 31, 2010, 2009, and 2008, we recorded approximately \$664,000, \$661,000, and \$772,000 of stock based compensation expense, respectively. We typically grant stock options to our management group on an annual basis, or when new members of the management group begin their employment. We grant stock options to members of our board of directors in conjunction with our annual shareholders meeting, or as new members are added on a pro rata basis based on the time elapsed since our annual shareholders meeting. We expect to continue this practice for the foreseeable future; however, we may adjust the size of the annual grant. As of December 31, 2010, total future compensation cost related to non-vested awards not yet recognized was \$950,377 net of estimated forfeitures, with a weighted average expense recognition period of 2.2 years. Future compensation expense recognition for new option grants will vary depending on the timing and size of new awards granted, changes in the market price or volatility of our common stock, changes in risk-free interest rates, or if actual forfeitures vary significantly from our estimates.

**Nonmonetary Exchange of Content Rights and Deferred Service Credits**

During 2009, we recorded content rights and deferred service credits of approximately \$665,000 in connection with a nonmonetary exchange with one of our customers. In order to account for this transaction, we estimated the fair value of the related assets and service credits, assessed whether the value assigned to the content was recoverable, and amortized the related assets over their estimated useful lives. Our future operating results will be impacted by the customer's utilization of the service credits. Revenues for services provided in exchange for service credits will be recognized in accordance with our revenue recognition policies.

**RESULTS OF OPERATIONS****Revenues and Expense Components**

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

*Revenues.* Revenues for our HealthStream Learning business segment primarily consist of the following products and services: provision of services through our Internet-based HLC, authoring tools, a variety of courseware subscriptions, implementation and consulting services, maintenance of third party content, content development, online sales training courses (RepDirect<sup>®</sup>), HospitalDirec<sup>®</sup>, and a variety of other educational activities for physicians, nurses and other professionals within healthcare organizations. Revenues for our HealthStream Research business segment consist of quality and satisfaction surveys, data analyses of survey results, and other research-based measurement tools focused on patients, physicians, employees, and other members of the community.

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

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

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*Sales and Marketing Expenses.* Sales and marketing expenses consist primarily of salaries, commissions and employee benefits, stock based compensation, employee travel and lodging, advertising, trade shows, promotions, and related marketing costs. During the past several years, excluding 2010 and 2009, we have hosted a national customer conference in Nashville known as The Summit, of which a significant portion of the costs are included in sales and marketing expenses. Personnel costs within sales and marketing include our Learning and Research sales teams, strategic account management, consultants, and marketing personnel, as well as our account management group.

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

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

*Other Income/Expense, Net.* The primary component of other income is interest income related to interest earned on cash, cash equivalents and investments in marketable securities. The primary component of other expense is interest expense related to a promissory note, capital leases and our revolving credit facility.

**2010 Compared to 2009**

*Revenues.* Revenues increased approximately \$8.4 million, or 14.6%, to \$65.8 million for 2010 from \$57.4 million for 2009. Revenues for 2010 consisted of \$45.2 million, or 69% of total revenue, for HealthStream Learning and \$20.6 million, or 31% of total revenue, for HealthStream Research. In 2009, revenues consisted of \$38.2 million, or 67% of total revenue, for HealthStream Learning and \$19.2 million, or 33% of total revenue, for HealthStream Research.

Revenues for HealthStream Learning increased approximately \$7.0 million, or 18.4%, over 2009. Revenues from our Internet-based subscription learning products increased by \$8.7 million over the prior year, and were comprised of revenue increases from the HLC of \$4.4 million and from courseware subscriptions of \$4.2 million. Revenues from our Internet-based subscription products increased 25.4% over the prior year due to a higher number of subscribers and more courseware consumption by subscribers. Our HLC subscriber base increased by 14% during 2010 to 2,250,000 fully-implemented subscribers at the end of 2010 compared to 1,974,000 fully-implemented subscribers at the end of 2009. Additionally, we had an 18% increase in contracted subscribers, with 2,450,000 contracted subscribers at December 31, 2010 compared to 2,073,000 contracted subscribers at December 31, 2009. Revenues associated with implementation, development, and consulting services decreased \$1.2 million from the prior year, and were impacted primarily by fewer engagements. Additionally, revenues from live events, study guides, and other project-based activities collectively declined \$489,000 from the prior year due to a de-emphasis on providing these services.

Revenues for HealthStream Research increased \$1.3 million, or 7.0%, over 2009. Revenues from recurring patient surveys increased by \$1.6 million, or 12.7%, over the prior year, primarily due to sales growth with new customers. Revenues from surveys conducted on annual or bi-annual cycles namely employee, physician, and community surveys decreased by \$299,000, primarily due to fewer projects than the prior year, as well as changes in the timing and size of the projects.

*Cost of Revenues (excluding depreciation and amortization).* Cost of revenues increased approximately \$2.9 million, or 13.3%, to \$24.2 million for 2010 from \$21.3 million for 2009. Cost of revenues as a percentage of revenues was 36.8% of revenues for 2010 compared to 37.2% of revenues for 2009. Cost of revenues for HealthStream Learning increased approximately \$1.6 million to \$13.5 million and approximated 30.0% and 31.3% of its revenues for 2010 and 2009, respectively. The overall expense increase is primarily associated with increased royalties paid by us resulting from growth in courseware subscription revenues, but was partially offset by expense decreases associated with the decline in implementation, development, and consulting service revenues. The decline as a percentage of revenue is attributable to the growth in subscription based revenues over the prior year. Cost of revenues for



HealthStream Research increased approximately \$1.3 million to \$10.7 million and approximated 51.8% and 48.8% of its revenues for 2010 and 2009, respectively. The increase in cost of revenues for HealthStream Research is primarily the result of costs associated with the growth in patient survey volume over the prior year. Additional costs were also incurred by our interview center operation during the second quarter of 2010 to complete projects on schedule in light of unprecedented snow storms experienced in the Baltimore area.

*Product Development.* Product development expenses increased approximately \$704,000, or 11.2%, to \$7.0 million for 2010 from \$6.3 million for 2009. Product development expenses as a percentage of revenues were 10.6% and 11.0% of revenues for 2010 and 2009, respectively.

Product development expenses for HealthStream Learning increased approximately \$253,000 and approximated 12.1% and 13.7% of its revenues for 2010 and 2009, respectively. The decrease as a percentage of revenue is the result of the growth in revenues over the prior year, while the expense increase is the result of personnel expenses associated with SimVentures. Product development expenses for HealthStream Research increased approximately \$451,000 and approximated 7.3% and 5.5% of its revenues for 2010 and 2009, respectively. This increase is primarily due to additional personnel associated with developing and supporting our survey reporting platform, Insights Online.

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*Sales and Marketing.* Sales and marketing expenses, including personnel costs, increased approximately \$2.2 million, or 19.4%, to \$13.1 million for 2010 from \$10.9 million for 2009. Sales and marketing expenses approximated 19.9% and 19.0% of revenues for 2010 and 2009, respectively.

Sales and marketing expenses for HealthStream Learning increased \$992,000 and approximated 18.4% and 19.2% of its revenues for 2010 and 2009, respectively. The expense increase is primarily associated with increased commissions due to better sales performance compared to the prior year. Sales and marketing expenses for HealthStream Research increased approximately \$1.0 million and approximated 21.2% and 17.3% of its revenues for 2010 and 2009, respectively. The expense increase for HealthStream Research resulted from additional sales personnel and commissions. The additional sales personnel were hired during the second half of 2009. These expense increases also impacted the increase as a percentage of revenues for HealthStream Research.

*Other General and Administrative.* Other general and administrative expenses increased approximately \$1.0 million, or 11.7% to \$9.6 million for 2010 from \$8.6 million for 2009. Other general and administrative expenses as a percentage of revenues approximated 14.6% and 14.9% for 2010 and 2009, respectively.

Other general and administrative expenses for HealthStream Learning increased \$82,000 compared to the prior year. Other general and administrative expenses for HealthStream Research decreased \$39,000 compared to the prior year. The unallocated corporate portion of other general and administrative expenses increased \$961,000 over the prior year, primarily associated with contract labor, software maintenance renewal fees, professional fees, rent expense, and other expenses.

*Depreciation and Amortization.* Depreciation and amortization decreased approximately \$259,000, or 5.1%, to \$4.9 million for 2010 from \$5.1 million for 2009. The decrease resulted from lower depreciation expense associated with certain assets reaching the end of their useful lives, and was partially offset by increased amortization of capitalized software features over the prior year. Amortization for HealthStream Learning increased \$64,000, or 3.5%, and approximated 4.2% and 4.8% of its revenues for 2010 and 2009, respectively. This expense increase was primarily associated with amortization of capitalized software feature enhancements. Amortization for HealthStream Research increased \$270,000, or 27.4%, and approximated 6.1% and 5.1% of its revenues for 2010 and 2009, respectively. This expense increase resulted from the amortization of capitalized software feature enhancements. The unallocated corporate portion decreased approximately \$593,000 associated with certain assets reaching the end of their depreciable lives.

*Other Expense, Net.* Other expense, net increased approximately \$6,000 to \$21,000 for 2010 from \$15,000 for 2009, and was associated with lower interest income resulting from lower yield rates on cash and cash equivalents.

*Income Tax Provision (Benefit).* The Company recorded a provision for income taxes of approximately \$2.9 million for 2010. The Company's effective tax rate for 2010 was approximately 41%. During 2009, the Company recorded a \$9.1 million income tax benefit offset by \$226,000 of current income tax expense. The income tax benefit in 2009 resulted from the reversal of a valuation allowance, which was based on management's conclusion that a portion of the Company's deferred tax assets would more likely than not be realized. Actual tax payments will be substantially less than our income tax provision until we utilize our federal and state net operating loss carry-forwards of approximately \$24.6 million and \$19.8 million, respectively, to offset taxable income.

*Net Income.* Net income was approximately \$4.2 million for 2010, compared to \$14.0 million for 2009. Net income per diluted share was \$0.18 per share for 2010 compared to \$0.64 per diluted share for 2009. Net income for 2010 includes an income tax provision of \$2.9 million, or \$0.13 per diluted share, while net income for 2009 included an income tax benefit of \$8.9 million, or \$0.41 per diluted share.

Adjusted EBITDA (which we define as net income before interest, income taxes, stock-based compensation, and depreciation and amortization) was approximately \$12.6 million for the year ended December 31, 2010, compared to \$10.9 million for the year ended December 31, 2009. This improvement is consistent with the factors mentioned in management's discussion and analysis of financial condition and results of operations herewith. Our reconciliation of this calculation to measures under US GAAP is listed in the table below.

In order to better assess the Company's financial results, management believes that adjusted EBITDA is an appropriate measure for evaluating the operating performance of the Company at this stage in its life cycle because adjusted EBITDA reflects net income adjusted for non-cash and non-operating items. Adjusted EBITDA is also used by many

investors and securities analysts to assess the Company's results from current operations. Adjusted EBITDA is a non-GAAP financial measure and should not be considered as a measure of financial performance under US GAAP. Because adjusted EBITDA is not a measurement determined in accordance with US GAAP, it is susceptible to varying calculations. Accordingly, adjusted EBITDA, as presented, may not be comparable to other similarly titled measures of other companies.

The Company understands that, although adjusted EBITDA is frequently used by investors and securities analysts in their evaluation of companies, this measure has limitations as an analytical tool, and you should not consider it in isolation, or as a substitute for an analysis of the Company's results as reported under US GAAP. For example, adjusted EBITDA does not reflect cash expenditures, or future requirements for capital expenditures or contractual commitments; it does not reflect non-cash components of employee compensation; it does not reflect changes in, or cash requirements for, our working capital needs; and due to the Company's utilization of federal and state net operating loss carryforwards in 2009 and 2010, actual cash income tax payments have been significantly less than the tax provision

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recorded in accordance with US GAAP, and income tax payments will continue to be less than the income tax provision until our existing federal and state net operating loss carryforwards have been fully utilized or have expired. Management compensates for the inherent limitations associated with using adjusted EBITDA through disclosure of such limitations, presentation of our financial statements in accordance with US GAAP, and a reconciliation of adjusted EBITDA to net income, the most directly comparable US GAAP measure.

Income before interest, taxes, stock-based compensation, depreciation and amortization, or adjusted EBITDA:

	Year Ended December 31,		
	2010	2009	2008
Net income	\$ 4,154,418	\$ 13,972,246	\$ 2,854,795
Interest income	(18,500)	(22,828)	(139,563)
Interest expense	40,925	40,695	61,526
Income taxes	2,884,287	(8,865,192)	(301,089)
Stock-based compensation expense	663,518	660,522	771,560
Depreciation and amortization	4,879,794	5,139,475	4,822,268
Income before interest, income taxes, share-based compensation, depreciation and amortization	\$ 12,604,442	\$ 10,924,918	\$ 8,069,497

**2009 Compared to 2008**

*Revenues.* Revenues increased approximately \$5.8 million, or 11.2%, to \$57.4 million for 2009 from \$51.6 million for 2008. Revenues for 2009 consisted of \$38.2 million, or 67% of total revenue, for HealthStream Learning and \$19.2 million, or 33% of total revenue, for HealthStream Research. In 2008, revenues consisted of \$32.8 million, or 64% of total revenue, for HealthStream Learning and \$18.8 million, or 36% of total revenue, for HealthStream Research.

Revenues for HealthStream Learning increased \$5.3 million, or 16.2%, over 2008. Revenues from our Internet-based subscription learning products increased by \$5.4 million over 2008, and were comprised of revenue increases from the HLC of \$3.0 million and from courseware subscriptions of \$2.4 million. Revenues from Internet-based subscription products increased 19% over the prior year due to an increase in the number of subscribers and more courseware consumption by subscribers. Our HLC subscriber base increased by 14% during 2009 to 1,974,000 fully-implemented subscribers at the end of 2009 compared to 1,732,000 fully-implemented subscribers at the end of 2008. Additionally, we had 2,073,000 contracted subscribers at December 31, 2009 compared to 1,855,000 contracted subscribers at December 31, 2008. Revenues associated with implementation, development, and consulting services increased \$1.2 million over the prior year due to increased courseware development service revenues compared to the prior year. These increases in revenues were partially offset by a decline in revenues from live events, study guides, and other project-based activities, which collectively declined \$1.3 million from the prior year due to a de-emphasis on live events and other similar project-based services.

Revenues for HealthStream Research increased \$476,000, or 2.5%, over 2008. Revenue from recurring patient surveys increased \$1.7 million, or 15%, over the prior year, but was offset by revenue declines from employee, physician, and community surveys of \$1.2 million. The revenue decline in these survey categories was generally attributable to customer decisions to defer conducting surveys based on budgetary, operational, and other considerations. Also during 2009, a portion of the revenue decrease was attributable to the loss of one customer contract.

*Cost of Revenues (excluding depreciation and amortization).* Cost of revenues increased approximately \$1.7 million, or 8.6%, to \$21.3 million for 2009 from \$19.7 million for 2008. Cost of revenues as a percentage of revenues was 37.2% of revenues for 2009 down favorably from 38.1% of revenues for 2008. Cost of revenues for HealthStream Learning increased approximately \$1.3 million to \$11.9 million and approximated 31.3% and 32.3% of its revenues for 2009 and 2008, respectively. The expense increase was primarily associated with increased royalties paid by us

resulting from growth in courseware subscription revenues as well as increased costs to support the growth in implementation, development, and consulting revenues, and was partially offset by expense decreases associated with the declines in live events and other project-based revenues. Cost of revenues for HealthStream Research increased approximately \$361,000 to \$9.4 million and approximated 48.8% and 48.2% of its revenues for 2009 and 2008, respectively. The increase in cost of revenues for HealthStream Research is primarily a result of the costs associated with increased survey volumes for our patient survey category compared to the prior year. Cost of revenues as a percentage of revenues for HealthStream Research was impacted favorably by improved operating efficiencies compared to the prior year, but was offset by the effect of lower revenues from the employee and physician survey categories.

*Product Development.* Product development expenses increased approximately \$615,000, or 10.9%, to \$6.3 million for 2009 from \$5.7 million for 2008. Product development expenses as a percentage of revenues were 11.0% of revenues for both 2009 and 2008.

Product development expenses for HealthStream Learning increased approximately \$597,000 and approximated 13.7% and 14.1% of its revenues for 2009 and 2008, respectively. This expense increase resulted from additional personnel expenses associated with both maintenance and support of our learning platform products and product portfolio management. Product development expenses for

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HealthStream Research increased approximately \$19,000, and approximated 5.5% of its revenues for both 2009 and 2008.

*Sales and Marketing.* Sales and marketing expenses, including personnel costs, increased approximately \$110,000, or 1.0%, and approximated \$10.9 million for 2009 compared to \$10.8 million for 2008. Sales and marketing expenses approximated 19.0% and 21.0% of revenues for 2009 and 2008, respectively. The decrease as a percentage of revenues was due to the overall growth in revenues over the prior year.

Sales and marketing expenses for HealthStream Learning increased \$231,000 and approximated 19.2% and 21.6% of its revenues for 2009 and 2008, respectively. This expense increase primarily resulted from increased sales personnel and commissions, but was partially offset by lower marketing expenses associated with our decision not to conduct our annual customer Summit during 2009. Sales and marketing expenses for HealthStream Research decreased approximately \$198,000, and approximated 17.3% and 18.8% of its revenues for 2009 and 2008, respectively. This expense decrease resulted primarily from fewer sales and marketing personnel and related expenses when compared to the prior year. The unallocated corporate portion of sales and marketing increased \$77,000 over the prior year due to additional personnel.

*Other General and Administrative.* Other general and administrative expenses increased approximately \$425,000, or 5.2%, and approximated \$8.6 million for 2009 compared to \$8.2 million for 2008. Other general and administrative expenses as a percentage of revenues decreased to 14.9% for 2009 from 15.8% for 2008. The percentage decrease was primarily a result of the revenue increases mentioned above.

Other general and administrative expenses for HealthStream Learning increased \$167,000 compared to the prior year, primarily due to employee bonuses and employee recruiting fees. Other general and administrative expenses for HealthStream Research decreased \$28,000 compared to the prior year, but included expense increases associated with employee bonuses, employee recruiting fees, and bad debt expense, and were offset by lower consulting expenses. The unallocated corporate portion of other general and administrative expenses increased \$286,000 compared to the prior year, and included expense increases associated with additional personnel and their related costs, employee bonuses, and fees for professional services, but was partially offset by lower stock based compensation expense, consulting expenses, facility costs, and employee recruiting fees.

*Depreciation and Amortization.* Depreciation and amortization increased approximately \$317,000, or 6.6%, to \$5.1 million for 2009 from \$4.8 million for 2008. The increase resulted from depreciation expense associated with capital expenditures and amortization of capitalized software features. Amortization for HealthStream Learning increased \$118,000, or 6.9%, and approximated 4.8% and 5.2% of its revenues for 2009 and 2008, respectively. This expense increase was primarily associated with amortization of capitalized software feature enhancements. Amortization for HealthStream Research decreased \$20,000, or 2.0%, and approximated 5.1% and 5.3% of its revenues for 2009 and 2008, respectively. This expense decrease resulted from certain intangible assets reaching the end of their estimated useful life. The unallocated corporate portion increased approximately \$219,000 associated with the depreciation of property and equipment.

*Other Income (Expense), Net.* Other income (expense), net decreased approximately \$87,000 to an expense of \$15,000 for 2009 from income of \$72,000 for 2008. Interest income decreased \$114,000 from the prior year period resulting from lower yield rates on cash and cash equivalents. Interest expense decreased \$27,000 from the prior year period due to reductions in debt and capital lease balances.

*Income Tax (Benefit) Provision.* The Company recognized a deferred income tax benefit of approximately \$9.1 million and \$375,000 during 2009 and 2008, respectively, through a reversal of the valuation allowance, which was based on management's conclusion that a portion of the Company's deferred tax assets would more likely than not be realized. During 2009, the \$9.1 million income tax benefit was partially offset by \$226,000 of current income tax expense. During 2008, the \$375,000 income tax benefit was partially offset by \$74,000 of current income tax expense. Taxable income for both 2009 and 2008 was substantially offset by the Company's net operating loss carryforwards.

*Net Income.* Net income was approximately \$14.0 million, or \$0.64 per diluted share, for the year ended December 31, 2009 up from \$2.9 million, or \$0.13 per diluted share for the year ended December 31, 2008. This increase was primarily the result of the \$9.1 million, or \$0.42 per diluted share, income tax benefit recognized during 2009 in addition to the changes in income from operations described above.

**FINANCIAL OUTLOOK FOR 2011**

The Company provides projections and other forward-looking information in this Financial Outlook for 2011 section within MD&A. This section contains many forward-looking statements, particularly relating to the Company's future financial performance. These forward-looking statements are estimates based on information currently available to the Company, are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995 and are subject to the precautionary statements set forth in the introduction in Part I of this Annual Report on Form 10-K above. Actual results are likely to differ, and in the past have differed, materially from those forecast by the Company, depending on the outcome of various factors, including, but not limited to, those set forth in Item 1A, Risk Factors.

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The Company anticipates that consolidated revenues for the full year 2011 will grow by 15 percent to 19 percent when compared to the full year 2010. We anticipate revenue growth in the Learning segment to be in the 16 percent to 20 percent range and the Research segment's revenue to increase by approximately 13 percent to 17 percent.

We anticipate that operating expenses will grow between 15 percent and 19 percent when compared to the Company's full year 2010 levels. These categories include cost of revenues, product development, sales and marketing, depreciation and amortization, and other general and administrative expense.

We expect that operating income will increase between 15 percent and 19 percent for the full year of 2011 versus our 2010 results.

We expect our effective book income tax rate for 2011 to be between 41 percent and 42 percent. Actual tax payments will be substantially less than our income tax provision as we continue to utilize our federal and state net operating loss carry-forwards of approximately \$25 million and \$20 million, respectively, to offset taxable income.

We expect that capital expenditures, including hardware, software and capitalized software development for new features, enhancements, content development, and additional office space will be approximately \$6.0 million during the full year of 2011.

**SELECTED QUARTERLY OPERATING RESULTS**

The following tables set forth selected statements of income data for each of the eight quarters in the period ended December 31, 2010 both in absolute dollars and as a percentage of total revenues. The information for each quarter has been prepared on the same basis as the audited statements included in other parts of this report and, in our opinion, includes all adjustments, consisting of only normal recurring adjustments, necessary for a fair presentation of the results of operations for these periods. You should read this information in conjunction with HealthStream's Consolidated Financial Statements and related notes thereto included elsewhere in this report. The operating results for any quarter are not necessarily indicative of the results to be expected in the future.

**Factors Affecting Quarterly Operating Results**

Revenues from our subscription products are recognized ratably over the subscription term. Survey and research revenues are impacted by seasonal factors resulting from the volume, timing, and frequency of survey cycles. During the fourth quarter of 2009 we recognized substantially all of our deferred tax assets, resulting in an income tax benefit of approximately \$9.1 million. During the second quarter of 2009, we corrected an accounting error associated with improperly expensing \$105,000 of software development costs incurred during the first quarter of 2009. The error correction resulted in a reduction of product development expenses and an increase to net income during the second quarter of 2009, but does not have an effect on net income for the year ended December 31, 2009. In addition, our expense for compensated absences may fluctuate from quarter to quarter, depending on vesting and utilization by our employees.

	Quarter Ended			
	March 31, 2010	June 30, 2010	September 30, 2010	December 31, 2010
	(In thousands, except per share data)			
STATEMENT OF INCOME DATA:				
Revenues, net	\$ 14,837	\$ 16,660	\$ 16,616	\$ 17,640
Operating costs and expenses:				
Cost of revenues (excluding depreciation and amortization)	5,462	5,906	6,274	6,548
Product development	1,526	1,723	1,750	1,990
Sales and marketing	2,961	3,050	3,358	3,685
Other general and administrative expenses	2,086	2,398	2,401	2,696
Depreciation and amortization	1,390	1,236	1,143	1,111



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Total operating costs and expenses	13,425	14,313	14,926	16,030
Income from operations	1,412	2,347	1,690	1,610
Other expense, net	(8)	(4)	(5)	(2)
Income before income taxes	1,404	2,343	1,685	1,608
Income tax provision	597	995	889	404
Net income	\$ 807	\$ 1,348	\$ 796	\$ 1,204
Net income per share <sup>(1)</sup> :				
Basic	\$ 0.04	\$ 0.06	\$ 0.04	\$ 0.06
Diluted	\$ 0.04	\$ 0.06	\$ 0.04	\$ 0.05
Weighted average shares of common stock outstanding:				
Basic	21,676	21,796	21,807	21,790
Diluted	22,130	22,433	22,511	22,878

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	<b>March</b>	<b>Quarter Ended</b>		<b>December</b>
	<b>31,</b>	<b>June 30,</b>	<b>September</b>	<b>31,</b>
	<b>2009</b>	<b>2009</b>	<b>30,</b>	<b>2009</b>
	<b>(In thousands, except per share data)</b>			
<b>STATEMENT OF INCOME DATA:</b>				
Revenues, net	\$ 13,619	\$ 14,584	\$ 14,105	\$ 15,090
Operating costs and expenses:				
Cost of revenues (excluding depreciation and amortization)	5,268	5,228	5,408	5,440
Product development	1,534	1,448	1,620	1,683
Sales and marketing	2,714	2,602	2,625	2,990
Other general and administrative expenses	1,901	2,194	2,068	2,414
Depreciation and amortization	1,266	1,250	1,305	1,318
Total operating costs and expenses	12,683	12,722	13,026	13,845
Income from operations	936	1,862	1,079	1,245
Other expense, net	(1)	(2)	(9)	(3)
Income before income taxes	935	1,860	1,070	1,242
Income tax provision (benefit)	57	132	47	(9,102)
Net income	\$ 878	\$ 1,728	\$ 1,023	\$ 10,344
Net income per share <sup>(1)</sup> :				
Basic	\$ 0.04	\$ 0.08	\$ 0.05	\$ 0.48
Diluted	\$ 0.04	\$ 0.08	\$ 0.05	\$ 0.47
Weighted average shares of common stock outstanding:				
Basic	21,382	21,382	21,464	21,601
Diluted	21,567	21,626	21,932	22,227

	<b>March</b>	<b>Quarter Ended</b>		<b>December</b>
	<b>31,</b>	<b>June 30,</b>	<b>September</b>	<b>31,</b>
	<b>2010</b>	<b>2010</b>	<b>30,</b>	<b>2010</b>
	<b>(% of Revenues)</b>			
<b>STATEMENT OF INCOME DATA:</b>				
Revenues	100.0	100.0	100.0	100.0
Operating costs and expenses:				
Cost of revenues (excluding depreciation and amortization)	36.8	35.5	37.8	37.1
Product development	10.3	10.3	10.5	11.3

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Sales and marketing	20.0	18.3	20.2	20.9
Other general and administrative expenses	14.1	14.4	14.5	15.3
Depreciation and amortization	9.4	7.4	6.9	6.3
Total operating costs and expenses	90.6	85.9	89.9	90.9
Income from operations	9.4	14.1	10.1	9.1
Other expense, net	0.0	0.0	0.0	0.0
Income before income taxes	9.4	14.1	10.1	9.1
Income tax provision	4.0	6.0	5.3	2.3
Net income	5.4	8.1	4.8	6.8

	March 31, 2009	June 30, 2009	Quarter Ended September 30, 2009	December 31, 2009
	(% of Revenues)			
STATEMENT OF INCOME DATA:				
Revenues	100.0	100.0	100.0	100.0
Operating costs and expenses:				
Cost of revenues (excluding depreciation and amortization)	38.7	35.9	38.3	36.0
Product development	11.3	9.9	11.4	11.2
Sales and marketing	19.9	17.8	18.6	19.8
Other general and administrative expenses	14.0	15.0	14.7	16.0
Depreciation and amortization	9.3	8.6	9.3	8.7
Total operating costs and expenses	93.2	87.2	92.3	91.7
Income from operations	6.8	12.8	7.7	8.3
Other expense, net	0.0	0.0	(0.1)	0.0
Income before income taxes	6.8	12.8	7.6	8.3
Income tax provision (benefit)	0.4	0.9	0.3	(60.3)
Net income	6.4	11.9	7.3	68.6

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

**Liquidity and Capital Resources**

Net cash provided by operating activities was approximately \$16.1 million during 2010 compared to \$11.6 million during 2009. Our primary sources of cash were generated from receipts from the sales of our products and services. The number of days sales outstanding (DSO) was 57 days for both 2010 and 2009. The Company calculates DSO by dividing the average accounts receivable balance (excluding unbilled and other receivables) by average daily revenues for the year. The primary uses of cash to fund our operations include personnel expenses, sales commissions, royalty payments, payments for contract labor and other direct expenses associated with delivery of our products and services, and general corporate expenses.

Net cash used in investing activities was approximately \$10.4 million for 2010, compared to \$3.1 million during 2009. During 2010, we purchased \$5.7 million of investments in marketable securities, \$2.6 million of property and

equipment, and spent \$2.0 million for software feature enhancements. During 2009, we purchased \$1.8 million of property and equipment, and spent \$1.3 million for software feature enhancements. The uses of cash for property and equipment and software feature enhancements were primarily associated with technology investments in our platform products, although purchases in 2010 also included build-out costs to accommodate the

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consolidation of operations of our Franklin, Tennessee office with our corporate office in Nashville, along with an expansion of our professional interviewing center in Baltimore, Maryland.

Net cash used in financing activities was approximately \$159,000 for 2010 compared to \$319,000 for 2009. The primary source of cash included proceeds associated with the issuance of common stock upon the exercise of employee stock options of \$536,000 and \$425,000, in 2010 and 2009, respectively. The primary uses of cash during 2010 included \$379,000 associated with a share repurchase plan and \$307,000 of payments under the promissory note. The primary use of cash during 2009 included \$724,000 of payments under the promissory note.

Our revenues increased and our operating income improved over the prior year period, and our balance sheet reflects positive working capital of \$19.5 million at December 31, 2010 compared to \$10.7 million at December 31, 2009. The improvement in working capital is primarily associated with increases in cash and cash equivalents and investments in marketable securities resulting from the net cash provided by operating activities mentioned above. Current assets increased approximately \$14.4 million during 2010 primarily a result of increases in cash and investments balances, accounts receivable, and prepaid assets, while current liabilities increased approximately \$5.6 million during 2010 resulting primarily from increases in deferred revenue, accounts payable and accrued liabilities. Our primary source of liquidity is \$23.6 million of cash and cash equivalents and investments in marketable securities. We also have a \$15.0 million revolving credit facility loan agreement, all of which was available at December 31, 2010.

We believe that our existing cash and cash equivalents, investments in marketable securities, related interest receivable, cash generated from operations, and available borrowings under our revolving credit facility will be sufficient to meet anticipated cash needs for working capital, new product development and capital expenditures for at least the next 12 months. As part of our growth strategy, we review possible acquisitions that complement our products and services. We anticipate that future acquisitions, if any, would be effected through a combination of stock and cash consideration. We may need to raise additional capital through the issuance of equity or debt securities and/or borrowings under our revolving credit facility, or another facility, to finance any future acquisitions. The issuance of our stock as consideration for an acquisition would have a dilutive effect and could adversely affect our stock price. Because we have no material debt or outstanding borrowings under our revolving credit facility, our balance sheet is unleveraged. Our revolving credit facility contains financial covenants and availability calculations designed to set a maximum leverage ratio of outstanding debt to equity. Therefore, if we were to borrow against our revolving credit facility, our debt capacity would be dependent on the covenant values at the time of borrowing. The credit markets have been experiencing extreme volatility and disruption, and we cannot assure you that if we need additional financing that it will be available on terms favorable to us, or at all. Failure to generate sufficient cash flow from operations or raise additional capital when required in sufficient amounts and on terms acceptable to us could harm our business, financial condition and results of operations.

**Commitments and Contingencies**

We expect that our capital expenditures, software feature enhancements, and content purchases will be approximately \$6.0 million in 2011. We expect to fund these capital expenditures with existing cash and investments and from cash generated from operations, and if necessary from our revolving credit facility. From January 1 through February 28, 2011, we had capital expenditures of approximately \$0.6 million, primarily related to leasehold improvements, hardware, software, and software feature enhancements.

Our strategic alliances have typically provided for payments to content partners based on revenues and development partners and other parties based on services rendered. We expect to continue similar arrangements in the future. We have commitments under capital lease obligations for computer hardware and operating lease commitments for our operating facilities in Nashville, Tennessee and Laurel, Maryland.

**Off-Balance Sheet Arrangements**

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

**Recent Accounting Pronouncements**

In September 2009, the Financial Accounting Standards Board ( FASB ) issued revised guidance on the accounting for revenue arrangements with multiple deliverables. The revised guidance changes when individual deliverables in a

multiple element arrangement can be treated as separate units of accounting, and also changes the manner in which the transaction consideration is allocated across the separately identified deliverables. The adoption of the guidance did not have an effect on the Company's financial position, results of operations, or cash flows.

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

We are exposed to market risk from changes in interest rates. We do not have any foreign currency exchange rate risk or commodity price risk. As of December 31, 2010, our outstanding indebtedness included approximately \$4,000 of capital lease obligations. We may become subject to interest rate market risk associated with any future borrowings under our revolving credit facility. The interest rate under the revolving credit facility is based on 30 Day LIBOR plus a margin of either 190 or 220 basis points determined in accordance

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with a pricing grid, but has a minimum interest rate of not less than three percent. We are also exposed to market risk with respect to our cash and investment balances. At December 31, 2010, the Company had cash and cash equivalents, investments in marketable securities, and related interest receivable totaling approximately \$23.6 million. Our current investment rates of return approximate 0.20%. Assuming a 0.20% rate of return on \$23.6 million, a hypothetical 10% decrease in interest rates would decrease interest income and decrease net income on an annualized basis by approximately \$4,700.

The Company manages its investment risk by investing in corporate debt securities, foreign corporate debt, secured corporate debt, and municipal debt securities with minimum acceptable credit ratings. For certificates of deposit and corporate obligations, ratings must be A1/A, BBB, FDIC insured or better; A1/P1 or better for commercial paper, and MIG 1/S, P/1 or better for municipal debt securities. The Company also requires that all securities must mature within 24 months from the original settlement date, the average portfolio shall not exceed 18 months, and the greater of 10% or \$5.0 million shall mature within 90 days. Further, the Company's investment policy also limits concentration exposure and other potential risk areas.

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

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

**INDEX TO CONSOLIDATED FINANCIAL STATEMENTS**

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

The Board of Directors and Shareholders of  
HealthStream, Inc.

We have audited the accompanying consolidated balance sheets of HealthStream, Inc. as of December 31, 2010 and 2009, and the related consolidated statements of income, shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2010. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of HealthStream, Inc. at December 31, 2010 and 2009, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2010, in conformity with U.S. generally accepted accounting principles.

/s/ Ernst & Young LLP

Nashville, Tennessee  
March 23, 2011

**Table of Contents****HEALTHSTREAM, INC.****CONSOLIDATED BALANCE SHEETS**

	<b>December 31, 2010</b>	<b>December 31, 2009</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 17,867,860	\$ 12,287,059
Investments in short-term marketable securities	5,703,192	
Restricted cash	84,528	65,855
Interest receivable	51,226	807
Accounts receivable, net of allowance for doubtful accounts of \$156,723 and \$140,559 at December 31, 2010 and 2009, respectively	11,069,108	9,577,409
Accounts receivable unbilled	1,314,025	1,638,326
Deferred tax assets, current	3,436,671	2,830,477
Prepaid royalties, net of amortization	3,145,297	2,084,154
Prepaid development fees, net of amortization	505,364	419,189
Other prepaid expenses and other current assets	1,093,510	987,583
<b>Total current assets</b>	<b>44,270,781</b>	<b>29,890,859</b>
Property and equipment:		
Equipment	14,347,683	14,121,140
Leasehold improvements	2,737,715	2,004,822
Furniture and fixtures	2,027,535	1,689,350
	19,112,933	17,815,312
Less accumulated depreciation and amortization	(15,287,579)	(14,881,423)
	3,825,354	2,933,889
Capitalized software feature enhancements, net of accumulated amortization of \$5,886,594 and \$3,993,689 at December 31, 2010 and 2009, respectively	4,332,705	4,181,858
Goodwill	21,146,864	21,146,864
Intangible assets, net of accumulated amortization of \$8,043,328 and \$7,096,196 at December 31, 2010 and 2009, respectively	2,843,814	3,790,946
Deferred tax assets, noncurrent	5,346,536	8,626,400
Other assets	244,649	431,464
<b>Total assets</b>	<b>\$ 82,010,703</b>	<b>\$ 71,002,280</b>
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 2,374,621	\$ 1,552,101
Accrued liabilities	4,044,320	3,322,794
Accrued compensation and related expenses	1,506,245	1,401,604
Commercial support liabilities	76,466	350,792
Deferred revenue	16,740,454	12,233,876

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Current portion of long term debt		306,942
Current portion of capital lease obligations	4,362	8,905
Total current liabilities	24,746,468	19,177,014
Other long term liabilities	473,897	
Capital lease obligations, less current portion		4,362
Commitments and contingencies		
Shareholders' equity:		
Common stock, no par value, 75,000,000 shares authorized; 21,805,235 and 21,623,350 shares issued and outstanding at December 31, 2010 and 2009, respectively	97,227,198	96,406,765
Accumulated other comprehensive income (loss)	(5,417)	
Accumulated deficit	(40,431,443)	(44,585,861)
Total shareholders' equity	56,790,338	51,820,904
Total liabilities and shareholders' equity	\$ 82,010,703	\$ 71,002,280

See accompanying notes to the consolidated financial statements.

**Table of Contents****HEALTHSTREAM, INC.****CONSOLIDATED STATEMENTS OF INCOME**

	<b>For the Year Ended December 31,</b>		
	<b>2010</b>	<b>2009</b>	<b>2008</b>
Revenues, net	\$ 65,754,263	\$ 57,398,230	\$ 51,599,543
Operating costs and expenses:			
Cost of revenues (excluding depreciation and amortization)	24,190,701	21,343,451	19,653,450
Product development	6,988,965	6,285,305	5,669,954
Sales and marketing	13,053,675	10,930,233	10,820,062
Other general and administrative expenses	9,581,565	8,577,488	8,152,291
Depreciation and amortization	4,879,794	5,139,475	4,822,268
Total operating costs and expenses	58,694,700	52,275,952	49,118,025
Income from operations	7,059,563	5,122,278	2,481,518
Other income (expense):			
Interest and other income	20,067	25,471	139,801
Interest and other expense	(40,925)	(40,695)	(67,613)
Total other income (expense), net	(20,858)	(15,224)	72,188
Income before income taxes	7,038,705	5,107,054	2,553,706
Income tax provision (benefit)	2,884,287	(8,865,192)	(301,089)
Net income	\$ 4,154,418	\$ 13,972,246	\$ 2,854,795
Net income per share:			
Basic	\$ 0.19	\$ 0.65	\$ 0.13
Diluted	\$ 0.18	\$ 0.64	\$ 0.13
Weighted average shares of common stock outstanding:			
Basic	21,766,915	21,457,517	21,707,364
Diluted	22,488,024	21,838,040	22,204,314

See accompanying notes to the consolidated financial statements.

**Table of Contents****HEALTHSTREAM, INC.****CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY**

	<b>Common Stock</b>		<b>Accumulated</b>	<b>Accumulated Other Comprehensive Income (Loss)</b>	<b>Total Shareholders Equity</b>
	<b>Shares</b>	<b>Amount</b>	<b>Deficit</b>		
Balance at December 31, 2007	22,315,485	\$ 97,126,520	\$ (61,412,902)	\$	\$ 35,713,618
Net income			2,854,795		2,854,795
Stock based compensation		771,560			771,560
Exercise of stock options	106,162	210,928			210,928
Issuance of common stock to Employee Stock Purchase Plan	53,108	130,911			130,911
Repurchase of common stock	(1,092,700)	(2,919,030)			(2,919,030)
Balance at December 31, 2008	21,382,055	95,320,889	(58,558,107)		36,762,782
Net income			13,972,246		13,972,246
Stock based compensation		660,522			660,522
Exercise of stock options	241,295	425,354			425,354
Balance at December 31, 2009	21,623,350	96,406,765	(44,585,861)		51,820,904
Net income			4,154,418		4,154,418
Unrealized loss on investments in marketable securities				(5,417)	(5,417)
Comprehensive income					4,149,001
Stock based compensation		663,519			663,519
Exercise of stock options	259,650	536,332			536,332
Repurchase of common stock	(77,765)	(379,418)			(379,418)
Balance at December 31, 2010	21,805,235	\$ 97,227,198	\$ (40,431,443)	\$ (5,417)	\$ 56,790,338

See accompanying notes to the consolidated financial statements.

**Table of Contents****HEALTHSTREAM, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS**

	<b>For the Year Ended December 31,</b>		
	<b>2010</b>	<b>2009</b>	<b>2008</b>
<b>OPERATING ACTIVITIES:</b>			
Net income	\$ 4,154,418	\$ 13,972,246	\$ 2,854,795
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	4,879,794	5,139,475	4,822,268
Deferred income taxes	2,673,670	(9,091,548)	(375,467)
Stock based compensation expense	663,519	660,522	771,560
Provision for doubtful accounts	65,000	150,000	130,000
Realized loss on disposal of property and equipment	1,011	3,974	15,933
Changes in operating assets and liabilities, excluding effects of acquisition:			
Restricted cash	(18,673)	(48,727)	(3,624)
Interest receivable	(50,419)	3,283	13,250
Accounts and unbilled receivables	(1,232,398)	(1,393,167)	(383,277)
Prepaid royalties	(1,061,143)	(1,088,661)	(677,930)
Prepaid development fees	(394,788)	(196,286)	(88,594)
Other prepaid expenses and other current assets	(105,927)	46,443	(374,706)
Other assets	187,929	129,894	186,773
Accounts payable	822,520	165,330	(428,901)
Accrued liabilities, accrued compensation and related expenses, and other long-term liabilities	1,300,064	1,081,435	(1,211,005)
Commercial support liabilities	(274,326)	3,558	82,184
Deferred revenue	4,506,578	2,031,567	709,339
Net cash provided by operating activities	16,116,829	11,569,338	6,042,598
<b>INVESTING ACTIVITIES:</b>			
Acquisitions, net of cash acquired			(9,194)
Purchases of investments in marketable securities	(5,709,723)		
Payments associated with capitalized software feature enhancements	(2,043,752)	(1,282,750)	(980,433)
Purchases of property and equipment	(2,623,620)	(1,787,297)	(1,138,598)
Net cash used in investing activities	(10,377,095)	(3,070,047)	(2,128,224)
<b>FINANCING ACTIVITIES:</b>			
Issuance of common stock to Employee Stock Purchase Plan			130,911
Proceeds from exercise of stock options	536,332	425,354	210,928
Repurchase of common stock	(379,418)		(2,919,030)
Payments on capital lease obligations	(8,905)	(20,103)	(123,219)
Payments on long-term debt	(306,942)	(724,095)	(706,698)

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Net cash used in financing activities	(158,933)	(318,844)	(3,407,108)
Net increase in cash and cash equivalents	5,580,801	8,180,447	507,266
Cash and cash equivalents at beginning of period	12,287,059	4,106,612	3,599,346
Cash and cash equivalents at end of period	\$ 17,867,860	\$ 12,287,059	\$ 4,106,612
<b>SUPPLEMENTAL CASH FLOW INFORMATION:</b>			
Interest paid	\$ 40,925	\$ 43,689	\$ 60,235
Income taxes paid	\$ 368,407	\$ 145,835	\$ 46,860
<b>NON-CASH INVESTING AND FINANCING ACTIVITIES:</b>			
Acquisition of content rights in exchange for future services	\$	\$ 665,000	\$

See accompanying notes to the consolidated financial statements.

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**HEALTHSTREAM, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Reporting Entity and Segments**

HealthStream, Inc. (the Company) was incorporated in 1990 as a Tennessee corporation and is headquartered in Nashville, Tennessee. We operate our business in two segments: 1) HealthStream Learning and 2) HealthStream Research. Our HealthStream Learning products consist of Internet-based services and solutions to meet the ongoing training, information, and education needs of the healthcare community. These solutions provide, deliver and track computer based education for our customers in the United States through our software-as-a-service (SaaS) model. HealthStream Research products offer healthcare organizations a wide range of quality and satisfaction surveys, analyses of survey results, and other research-based services.

**Recognition of Revenue**

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

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

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

Revenues derived from the delivery of services through the Company's Internet-based learning products and courseware subscriptions are recognized ratably over the term of the subscription service agreement. Other training revenues are generally recognized upon the completion of training.

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

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



**Table of Contents****HEALTHSTREAM, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)****Principles of Consolidation**

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

**Use of Estimates**

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

**Cash and Cash Equivalents**

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

**Restricted Cash**

Cash received for registration fees is classified as restricted cash on the accompanying consolidated balance sheets. The use of this cash is restricted because it is held on behalf of the commercial supporter until services have been rendered, at which time the registration fees are used to pay certain expenses and fees for conducting those services. Excess registration funds are typically remitted to the commercial supporter or applied to other projects. Any deficiency in registration funds is billed to the commercial supporter.

**Investments in Marketable Securities**

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

**Accounts Receivable-Unbilled and Deferred Revenue**

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

**Allowance for Doubtful Accounts**

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

Changes in the allowance for doubtful accounts and the amounts charged to bad debt expense were as follows:

<b>Allowance</b>			
<b>Balance at</b>	<b>Charged to</b>		<b>Allowance</b>
	<b>Costs</b>		<b>Balance</b>
	<b>and Expenses</b>	<b>Write-offs</b>	

Year ended December 31,	<b>Beginning of Period</b>		<b>at End of Period</b>					
2010	\$	140,559	\$	65,000	\$	48,836	\$	156,723
2009	\$	106,542	\$	150,000	\$	115,983	\$	140,559
2008	\$	72,895	\$	130,000	\$	96,353	\$	106,542

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**Table of Contents****HEALTHSTREAM, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)****Capitalized Software Feature Enhancements**

Capitalized software feature enhancements are stated on the basis of cost, and are presented net of accumulated amortization. The Company capitalizes costs incurred during the software development phase for projects when such costs are material. These assets are amortized using the straight-line method, generally over one to four years. The Company capitalized approximately \$2.0 million and \$1.3 million during 2010 and 2009, respectively. Maintenance and operating costs are expensed as incurred. As of December 31, 2010 and 2009, there were no capitalized internal development costs for computer software developed for resale.

**Property and Equipment**

Property and equipment are stated on the basis of cost. Depreciation and amortization are provided on the straight-line method over the following estimated useful lives, except for assets under capital leases and leasehold improvements, which are amortized over the shorter of the estimated useful life or their respective lease term. Depreciation and amortization of property and equipment totaled \$1,731,144 and \$2,324,297 for the years ended December 31, 2010 and 2009, respectively.

	<b>Years</b>
Furniture and fixtures	5-10
Equipment	3-5

**Goodwill and Intangible Assets**

Goodwill represents the excess of purchase price over fair value of net tangible assets acquired. The Company measures goodwill for impairment at the reporting unit level using both income and market based models to determine the fair value of the reporting units. The Company will perform its goodwill impairment test whenever events or changes in facts or circumstances indicate that impairment may exist, or at least annually during the fourth quarter each year.

Intangible assets acquired through acquisitions are comprised of content, contract rights, customer relationships, non-competition agreements and favorable lease rights. As of December 31, 2010 intangible assets with remaining unamortized balances include contract rights, customer relationships and non-competition agreements recorded in connection with the acquisitions of The Jackson Organization, Research Consultants, Inc. (TJO) and Data Management and Research, Inc. (DMR). Intangible assets are considered to have definite useful lives and are being amortized on a straight line basis over the expected periods to be benefited, generally three to five years for content, two to eight years for contract rights, customer lists and customer relationships, six months to four years for non-competition agreements, and over the lease term for favorable lease rights. The weighted average amortization period for definite lived intangible assets as of December 31, 2010 is 7.7 years. Intangible assets are reviewed for impairment whenever events or changes in facts or circumstances indicate that the carrying amount of the assets may not be recoverable. There were no impairments identified or recorded for the years ended December 31, 2010, 2009, or 2008.

**Long-Lived Assets**

Long-lived assets to be held for use are reviewed for events or changes in facts and circumstances, both internally and externally, which may indicate that an impairment of long-lived assets held for use are present. The Company measures any impairment using observable market values or discounted future cash flows from the related long-lived assets. The cash flow estimates and discount rates incorporate management's best estimates, using appropriate and customary assumptions and projections at the date of evaluation. Management periodically evaluates whether the carrying value of long-lived assets, including property and equipment, capitalized software feature enhancements, other assets and intangible assets will be recoverable. There were no impairments identified or recorded for the years ended December 31, 2010, 2009, or 2008.

**Other Assets**

Other assets are comprised of the long-term portion of content development fees and other assets of a long-term nature.

**Table of Contents****HEALTHSTREAM, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)****Income Taxes**

Income taxes are accounted for using the asset and liability method, whereby deferred tax assets and liabilities are determined based on the temporary differences between the financial statement and tax bases of assets and liabilities measured at tax rates that will be in effect for the year in which the differences are expected to affect taxable income. Management evaluates all available evidence, both positive and negative, to determine whether, based on the weight of that evidence, a valuation allowance is needed. Future realization of the tax benefit of an existing deductible temporary difference or carryforward ultimately depends on the existence of sufficient taxable income of the appropriate character within the carryback or carryforward period available under the tax law. There are four possible sources of taxable income that may be available under the tax law to realize a tax benefit for deductible temporary differences and carryforwards: 1) future reversals of existing taxable temporary differences, 2) future taxable income exclusive of reversing temporary differences and carryforwards, 3) taxable income in prior carryback year(s) if carryback is permitted under the tax law, and 4) tax-planning strategies that would, if necessary, be implemented to realize deductible temporary differences or carryforwards prior to their expiration. Management reviews the realizability of its deferred tax assets each reporting period to identify whether any significant changes in circumstances or assumptions have occurred that could materially affect the realizability of deferred tax assets. As of December 31, 2010, the Company has established a valuation allowance of \$1.1 million for the portion of its net deferred tax assets that are not more likely than not expected to be realized.

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

**Commercial Support Liabilities**

Commercial support liabilities represent grant funds received from entities supporting educational activities, in which we are the accredited provider. The funds are unrestricted, and are primarily used to pay for expenses associated with conducting the activities.

**Accrual for Service Credits**

The Company maintains an accrual for service credits that may occur from our Internet-based learning products. The accrual is estimated using management's judgment and analysis of potential risk of loss associated with downtime, system performance, or other contractual obligations associated with our hosted applications. At December 31, 2010, and 2009, the accrual for service credits balance was approximately \$194,000 and \$318,000, respectively, and is included on the accompanying consolidated balance sheets under the caption accrued liabilities.

**Other Long Term Liabilities**

Other long term liabilities represent the deferred rent liability associated with an operating lease for office space in Nashville, Tennessee.

**Advertising**

The Company expenses the costs of advertising as incurred. Advertising expense for the years ended December 31, 2010, 2009, and 2008 was approximately \$130,000, \$137,000, and \$284,000, respectively.

**Shipping and Handling Costs**

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

**Table of Contents****HEALTHSTREAM, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)****Product Development Costs**

Product development costs include internal and external costs to develop and convert content for our Internet-based learning products. We capitalize the cost of content developed by third parties where the life expectancy is greater than one year and the anticipated cash flows from such content is expected to exceed its cost. The Company capitalized approximately \$57,000 and \$84,000 of content development costs during 2010 and 2009, respectively. Capitalized content development costs are included in the accompanying consolidated balance sheets under the captions prepaid development fees and other assets. We amortize content development over its expected life, which is generally one to three years. Content development costs that have been capitalized are subject to a periodic impairment review in accordance with our policy. The Company did not capitalize any internal web site development costs during 2010 or 2009, since the costs incurred were related to planning or operation of such products and sites.

**Net Income Per Share**

Basic net income per share is computed by dividing the net income available to common shareholders for the period by the weighted average number of common shares outstanding during the period. Diluted net income per share is computed by dividing the net income for the period by the weighted average number of common and common equivalent shares outstanding during the period. Common equivalent shares, composed of incremental common shares issuable upon the exercise of stock options and warrants, escrowed or restricted shares, and shares subject to vesting are included in diluted net income per share to the extent these shares are dilutive. Common equivalent shares that have an anti-dilutive effect on diluted net income per share have been excluded from the calculation of diluted weighted average shares outstanding for the years ended December 31, 2010, 2009, and 2008.

**Concentrations of Credit Risk and Significant Customers**

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

The Company sells its products and services to various companies in the healthcare industry that are located in the United States. We perform ongoing credit evaluations of our customers' financial condition and generally require no collateral from customers. The Company did not have any single customer representing over 10% of net revenues during 2010, 2009, or 2008.

**Stock Based Compensation**

As of December 31, 2010, the Company maintains a stock based compensation plan, which is described in Note 12. The Company accounts for stock based compensation using the fair-value based method for costs related to share-based payments, including stock options. The Company uses the Black Scholes option pricing model for calculating the fair value of awards issued under its stock based compensation plan. Stock based compensation cost is measured at the grant date, based on the fair value of the award that is ultimately expected to vest, and is recognized as an expense over the requisite service period.

**Fair Value of Financial Instruments**

The following methods and assumptions were used in estimating fair value for financial instruments:

*Cash and cash equivalents and restricted cash:* The carrying amounts approximate the fair value because of the short-term maturity or short-term nature of such instruments.

*Accounts receivable, accounts receivable-unbilled, interest receivable, accounts payable, accrued liabilities and deferred revenue:* The carrying amounts, net of any allowance for doubtful accounts, approximate the fair value because of the short-term nature of such instruments.

*Investments in marketable securities:* The carrying amounts approximate the fair value based on quoted market prices. See Note 5.

*Promissory note:* The carrying amount approximates fair value based on current market rates for similar arrangements available to the Company.

**Table of Contents****HEALTHSTREAM, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)****Newly Issued Accounting Standards**

In September 2009, the Financial Accounting Standards Board ( FASB ) issued revised guidance on the accounting for revenue arrangements with multiple deliverables. The revised guidance changes when individual deliverables in a multiple element arrangement can be treated as separate units of accounting, and also changes the manner in which the transaction consideration is allocated across the separately identified deliverables. The adoption of the guidance did not have an effect on the Company's financial position, results of operations, or cash flows.

**2. SHAREHOLDERS' EQUITY****Common Stock**

The Company is authorized to issue up to 75 million shares of common stock. The number of common shares issued and outstanding as of December 31, 2010 and 2009 was 21,805,235 and 21,623,350, respectively. During February 2010, our Board of Directors authorized the Company to purchase up to \$4.0 million of its common stock over a one year period. During 2010, the Company purchased 77,765 shares at an average price of \$4.88 per share.

**Preferred Stock**

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

**3. NET INCOME PER SHARE**

The following table sets forth the computation of basic and diluted net income per share:

	<b>Year Ended December 31,</b>		
	<b>2010</b>	<b>2009</b>	<b>2008</b>
Numerator:			
Net income	\$ 4,154,418	\$ 13,972,246	\$ 2,854,795
Denominator:			
Weighted-average shares outstanding:			
Basic	21,766,915	21,457,417	21,707,364
Employee stock options and escrowed shares	721,109	380,623	496,950
Diluted	22,488,024	21,838,040	22,204,314
Net income per share:			
Basic	\$ 0.19	\$ 0.65	\$ 0.13
Diluted	\$ 0.18	\$ 0.64	\$ 0.13

For the years ended December 31, 2010, 2009, and 2008, the calculation of weighted average and equivalent shares excluded options and warrants that were anti-dilutive. The equivalent common shares related to such options and warrants were 397,875 in 2010, 1,478,664 in 2009, and 1,913,082 in 2008.

**Table of Contents****HEALTHSTREAM, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****4. INVESTMENTS IN MARKETABLE SECURITIES**

At December 31, 2010, the fair value of investments in marketable securities, which were all classified as current and available-for-sale, included the following:

	<b>Amortized Cost</b>	<b>Unrealized Losses</b>	<b>Fair Value</b>
Corporate debt securities	\$ 3,201,094	\$ (2,607)	\$ 3,198,487
Municipal debt securities	2,507,515	(2,810)	2,504,705
	\$ 5,708,609	\$ (5,417)	\$ 5,703,192

All of the above debt securities at December 31, 2010 mature within one year.

**5. FAIR VALUE OF FINANCIAL INSTRUMENTS**

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

Level 1 Observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2 Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. Level 2 inputs include quoted prices for similar assets or liabilities in active markets, or quoted market prices for identical or similar assets and liabilities in markets that are not active.

Level 3 Unobservable inputs in which little or no market data exists, therefore requiring the Company to develop its own assumptions.

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

**Assets and Liabilities Measured at Fair Value on a Recurring Basis**

The assets and liabilities that are measured at fair value on a recurring basis as of December 31, 2010 were as follows:

	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>
Available-for-sale securities	\$ 5,703,192	\$	\$

The Company's investments in marketable securities consist of Corporate and Municipal debt securities classified as available for sale. The carrying amounts reported in the condensed consolidated balance sheets approximate the fair value of the Company's investments in marketable securities based on quoted market prices.

At December 31, 2010 and 2009, the Company did not have any financial liabilities that were subject to fair value measurements.



**Table of Contents****HEALTHSTREAM, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****6. GOODWILL**

Goodwill is tested for impairment at least annually using a fair value method. The Company tests goodwill for impairment using both income and market based models. The technique used to determine the fair value of our reporting units is sensitive to estimates and assumptions associated with cash flow from operations and its growth, discount rates, and reporting unit terminal values. If these estimates or their related assumptions change in the future, we may be required to record additional impairment charges, which could adversely impact our operating results for the period in which such a determination is made. The Company performs its annual impairment evaluation of goodwill during the fourth quarter of each year and as changes in facts and circumstances indicate impairment exists. During the annual impairment evaluation in the fourth quarter of 2010 and 2009, the results of our goodwill impairment analysis indicated the fair value of our reporting units exceeded their carrying values. Therefore no impairment existed at December 31, 2010 and 2009.

Goodwill for HealthStream Learning totaled \$3,306,688 at December 31, 2010 and 2009, and goodwill for HealthStream Research totaled \$17,840,176 at December 31, 2010 and 2009. There were no changes in the carrying amount of goodwill during the years ended December 31, 2010 and 2009. On January 1, 2002, upon the adoption of FASB guidance for goodwill and other intangible assets, the Company recorded a \$5.0 million goodwill impairment charge for HealthStream Learning.

**7. INTANGIBLE ASSETS**

All intangible assets are considered to have finite useful lives. Customer related intangible assets include contract rights, customer lists, and customer relationships associated with our acquisitions of DMR and TJO. Other intangible assets include non-competition agreements associated with the same acquired entities. The intangibles are being amortized over their estimated useful lives, ranging from one to eight years. Amortization of intangible assets was approximately \$947,000, \$947,000, and \$967,000, for the years ended December 31, 2010, 2009 and 2008, respectively.

Identifiable intangible assets are comprised of the following:

	As of December 31, 2010			As of December 31, 2009		
	Accumulated			Accumulated		
	Gross Amount	Amortization	Net	Gross Amount	Amortization	Net
Customer related	\$ 9,915,000	\$ (7,085,849)	\$ 2,829,151	\$ 9,915,000	\$ (6,213,974)	\$ 3,701,026
Other	972,142	(957,479)	14,663	972,142	(882,222)	89,920
Total	\$ 10,887,142	\$ (8,043,328)	\$ 2,843,814	\$ 10,887,142	\$ (7,096,196)	\$ 3,790,946

Estimated amortization expense for the years ending December 31, is as follows:

2011	\$ 886,537
2012	871,875
2013	549,632
2014	446,875
2015	88,895
Total	\$ 2,843,814

**8. CONTENT RIGHTS AND DEFERRED SERVICE CREDITS**

During 2009, the Company entered into a renewal agreement with a customer in which the Company was provided continued rights to distribute and resell courseware owned by them. In exchange for the receipt of an exclusive license

to distribute and resell this courseware, the Company provided the customer with service credits that can be exchanged for future purchases of the Company's products and services. The value assigned to the content rights and the deferred service credits was \$665,000, which represented the estimated fair value of the assets relinquished. The content rights are classified within prepaid development fees and other assets, and the deferred service credits are classified within accrued liabilities on our condensed consolidated balance sheets as of December 31, 2010 and 2009.

**Table of Contents****HEALTHSTREAM, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****8. CONTENT RIGHTS AND DEFERRED SERVICE CREDITS (continued)**

These exchangeable service credits will be issued annually through December 31, 2011, and will expire twenty-four months after issuance. Any unused credits will be forfeited upon expiration. During the years ended December 31, 2010 and 2009, the Company issued exchangeable service credits of \$100,000 and \$465,000, respectively, in accordance with this agreement, and is obligated to issue remaining service credits of \$100,000 in 2011. The content rights are being amortized on a straight-line basis through December 31, 2012. Revenues for products or services provided in exchange for these service credits will be recognized in accordance with our revenue recognition policies.

**9. COLLABORATIVE ARRANGEMENT**

On June 23, 2010, the Company announced the formation of SimVentures, a collaborative arrangement between HealthStream and Laerdal Medical Corporation. SimVentures will offer products and services aimed at accelerating the global adoption of simulation-based learning by healthcare providers with a focus on improving clinical competencies and patient outcomes. The Company will receive 50 percent of the profits or losses generated from the collaborative arrangement. A legal entity was not formed as part of the collaborative arrangement, therefore, the Company is accounting for SimVentures as a collaborative arrangement in accordance with applicable accounting guidance. SimVentures is currently in the product development phase, and sales activity is expected to commence during 2011. During the year ended December 31, 2010, the Company recorded approximately \$413,000 of expenses related to the collaborative arrangement, which are primarily recorded in the product development category within the statements of income. The Company also recorded approximately \$282,000 of capitalized software feature enhancements during 2010. SimVentures is included in the HealthStream Learning business segment.

**10. BUSINESS SEGMENTS**

The Company provides services to healthcare organizations, pharmaceutical and medical device companies, and other members within the healthcare industry. These services are primarily focused on the delivery of education and training products and services (HealthStream Learning), as well as survey and research services (HealthStream Research). HealthStream Learning products and services include our Internet-based HealthStream Learning Center®, authoring tools, courseware subscriptions, online training and content development, online sales training courses, HospitalDirect® and other products focused on education and training to serve professionals that work within healthcare organizations. HealthStream Research products and services include Patient Insights, Employee Insights, Physician Insights, and Community Insights surveys, along with the Improvement Center, national benchmarks, HCAHPS Improvement Library, consulting services, and other support tools.

The following is the Company's business segment information as of and for the years ended December 31, 2010, 2009 and 2008. The Company measures segment performance based on operating income before income taxes and prior to the allocation of certain corporate overhead expenses, interest income, interest expense, and depreciation. The Unallocated component below includes corporate functions, such as accounting, human resources, legal, investor relations, administrative, and executive personnel, depreciation, a portion of amortization, and certain other expenses, which are not currently allocated in measuring segment performance.

	Year ended December 31, 2010			Consolidated
	Learning	Research	Unallocated	
Revenues, net	\$ 45,165,253	\$ 20,589,010	\$	\$ 65,754,263
Cost of revenues (excluding depreciation and amortization)	13,528,252	10,662,449		24,190,701
Product development	5,484,337	1,504,628		6,988,965
Sales and marketing	8,310,131	4,372,034	371,510	13,053,675
Other general and administrative	1,865,646	1,823,864	5,892,055	9,581,565
Depreciation and amortization	1,896,435	1,252,214	1,731,145	4,879,794
Total income from operations	\$ 14,080,452	\$ 973,821	\$ (7,994,710)	\$ 7,059,563

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*Segment assets	\$ 18,730,859	\$ 26,701,566	\$ 36,578,278	\$ 82,010,703
Purchases of property and equipment	\$ 1,172,471	\$ 399,891	\$ 1,051,258	\$ 2,623,620
Payments associated with capitalized software feature enhancements	\$ 1,794,514	\$ 249,238	\$	\$ 2,043,752

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**Table of Contents****HEALTHSTREAM, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****10. BUSINESS SEGMENTS (continued)**

	Year ended December 31, 2009			Consolidated
	Learning	Research	Unallocated	
Revenues, net	\$ 38,153,924	\$ 19,244,306	\$	\$ 57,398,230
Cost of revenues (excluding depreciation and amortization)	11,945,931	9,397,520		21,343,451
Product development	5,231,410	1,053,895		6,285,305
Sales and marketing	7,318,205	3,324,589	287,439	10,930,233
Other general and administrative	1,784,121	1,862,433	4,930,934	8,577,488
Depreciation and amortization	1,832,542	982,636	2,324,297	5,139,475
Total income from operations	\$ 10,041,715	\$ 2,623,233	\$ (7,542,670)	\$ 5,122,278
*Segment assets	\$ 18,185,466	\$ 26,209,873	\$ 26,606,941	\$ 71,002,280
Purchases of property and equipment	\$ 1,131,642	\$ 168,055	\$ 487,600	\$ 1,787,297
Payments associated with capitalized software feature enhancements	\$ 783,786	\$ 498,964	\$	\$ 1,282,750
	Year ended December 31, 2008			Consolidated
	Learning	Research	Unallocated	
Revenues, net	\$ 32,831,640	\$ 18,767,903	\$	\$ 51,599,543
Cost of revenues (excluding depreciation and amortization)	10,616,573	9,036,877		19,653,450
Product development	4,634,664	1,035,290		5,669,954
Sales and marketing	7,087,094	3,522,928	210,040	10,820,062
Other general and administrative	1,617,432	1,889,971	4,644,888	8,152,291
Depreciation and amortization	1,714,119	1,002,527	2,105,622	4,822,268
Total income from operations	\$ 7,161,758	\$ 2,280,310	\$ (6,960,560)	\$ 2,481,518
*Segment assets	\$ 16,027,451	\$ 27,018,000	\$ 9,751,430	\$ 52,796,882
Purchases of property and equipment	\$ 594,816	\$ 118,328	\$ 425,454	\$ 1,138,598
Payments associated with capitalized software feature enhancements	\$ 513,540	\$ 466,893	\$	\$ 980,433

\* Segment assets include restricted cash, accounts and unbilled receivables, prepaid and other current assets, other assets, capitalized software feature enhancements, certain property and equipment, and intangible assets. Cash and cash equivalents and investments in marketable securities are not allocated to individual segments, and are

included within Unallocated. A significant portion of property and equipment assets are included within Unallocated.

**11. INCOME TAXES**

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

	<b>Year Ended December 31,</b>		
	<b>2010</b>	<b>2009</b>	<b>2008</b>
Current federal	\$ 145,697	\$ 116,401	\$ 19,450
Current state	64,920	109,955	54,928
Deferred federal	2,515,383	(8,134,543)	(335,944)
Deferred state	158,287	(957,005)	(39,523)
Provision (benefit) for income taxes	\$ 2,884,287	\$ (8,865,192)	\$ (301,089)

**Table of Contents****HEALTHSTREAM, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****11. INCOME TAXES (continued)**

The provision (benefit) for income taxes differs from the amounts computed by applying the federal statutory rate of 34% to the income before income taxes as follows:

	<b>Year Ended December 31,</b>		
	<b>2010</b>	<b>2009</b>	<b>2008</b>
Federal tax provision at the statutory rate	\$ 2,391,318	\$ 1,736,259	\$ 868,360
State income tax provision, net of federal benefit	309,152	202,223	135,883
Other	183,817	229,484	335,641
Decrease in valuation allowance		(11,033,158)	(1,640,973)
Provision (benefit) for income taxes	\$ 2,884,287	\$ (8,865,192)	\$ (301,089)

Management periodically assesses the realizability of its deferred tax assets, and to the extent that a recovery is not likely, a valuation allowance is established to reduce the deferred tax asset to the amount estimated to be recoverable. During 2009, the valuation allowance decreased \$11,033,158, of which \$9,091,548 was associated with the Company's conclusion that substantially all of its deferred tax assets will be realized in future periods. During 2008, the Company released \$375,467 of the valuation allowance. At December 31, 2010, a valuation allowance of \$1,093,699 exists for the remaining portion of deferred tax assets, which are comprised of the portion of net operating loss carryforwards attributable to the exercises of stock options. Any future reductions of the valuation allowance associated with this deferred tax asset would be recognized as an increase to common stock.

As of December 31, 2010, the Company had federal and state net operating loss carryforwards of \$24,645,179 and \$19,781,583, respectively. These loss carryforwards will expire in years 2012 through 2024. As of December 31, 2010, \$3,240,478 of the net operating loss carryforwards is attributable to the exercise of stock options, and if realized, the tax benefit will be recorded as an increase to common stock. The net operating loss carryforwards are subject to annual limitations under Internal Revenue Code Section 382. The annual limitations could result in the expiration of a portion of net operating loss and tax credit carryforwards before they are fully utilized.

The Company has research and development tax credit carryforwards of \$285,787 that expire in varying amounts through 2024. As of December 31, 2010, the Company has alternative minimum tax credit carryforwards of \$360,754 that are available to offset future regular tax liabilities and they do not expire. Federal income tax payments of \$191,000, \$95,000 and \$5,300, were made during the years ended December 31, 2010, 2009, and 2008, respectively. State income tax payments of \$177,407, \$50,835, and \$41,560 were made during the years ended December 31, 2010, 2009, and 2008, respectively.

As of December 31, 2010 and 2009, the Company's consolidated balance sheets did not reflect a liability for uncertain tax positions, nor any accrued penalties or interest associated with income tax uncertainties. The Company is subject to income taxation at the federal and various state levels. The Company is subject to U.S. federal tax examinations for tax years 2007 through 2010. Loss carryforwards and credit carryforwards generated or utilized in years earlier than 2007 are also subject to examination and adjustment. The Company has no income tax examinations in process.

**Table of Contents****HEALTHSTREAM, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****11. INCOME TAXES (continued)**

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

	<b>December 31,</b>	
	<b>2010</b>	<b>2009</b>
Current deferred tax assets:		
Allowance for doubtful accounts	\$ 59,544	\$ 53,412
Accrued liabilities	753,953	707,050
Net operating loss carryforwards	3,015,898	2,320,194
	3,829,395	3,080,656
Less: Valuation allowance	(392,724)	(250,179)
Net current deferred tax assets	\$ 3,436,671	\$ 2,830,477
Noncurrent deferred tax assets:		
Depreciation	\$ 319,170	\$ 301,388
Research and development credits	285,787	285,787
Stock based compensation	205,924	154,430
Alternative minimum tax credits	360,754	215,057
Net operating loss carryforwards	6,265,284	9,721,833
	7,436,919	10,678,495
Less: Valuation allowance	(700,975)	(843,520)
Net noncurrent deferred tax assets	\$ 6,735,944	\$ 9,834,975
Noncurrent deferred tax liabilities:		
Deductible goodwill	\$ 673,750	\$ 291,565
Nondeductible intangible assets	715,658	917,010
Total noncurrent deferred tax liabilities	\$ 1,389,408	\$ 1,208,575
Net noncurrent deferred tax asset	\$ 5,346,536	\$ 8,626,400

**12. STOCK BASED COMPENSATION**

Total stock based compensation expense recorded for the years ended December 31, 2010, 2009, and 2008, which is recorded in our statements of income, is as follows:

	<b>Years Ended December 31,</b>		
	<b>2010</b>	<b>2009</b>	<b>2008</b>
Cost of revenues (excluding depreciation and amortization)	\$ 37,067	\$ 22,722	\$ 45,479



Product development	127,682	113,324	157,969
Sales and marketing	161,675	199,529	199,832
Other general and administrative	337,095	324,947	368,280
Total stock based compensation expense	\$ 663,519	\$ 660,522	\$ 771,560

#### Stock Option Plan

The Company's 2010 Stock Incentive Plan (the Plan) authorizes the grant of options or other forms of stock based compensation to employees, officers, directors and others, and such grants must be approved by the Compensation Committee of the Board of Directors. Options granted under the Plan have terms of no more than ten years, with certain restrictions. The Plan allows the Compensation Committee of the Board of Directors to determine the vesting period of each grant. The vesting period of the options granted ranges from immediate vesting to annual vesting up to four years, beginning one year after the grant date. As of December 31, 2010, 1,372,500 shares of unissued common stock remained reserved for future grants under the Plan. The Company issues new shares of common stock when options are exercised.

**Table of Contents****HEALTHSTREAM, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****12. STOCK BASED COMPENSATION**

The weighted average fair value of options granted was estimated using the Black-Scholes method. The ranges of assumptions used for these estimates include:

	2010		2009		2008	
Risk-free interest rate	1.88	2.49%	1.73	3.22%	2.63	3.56%
Expected dividend yield		0.0%		0.0%		0.0%
Expected life (in years)	5 to 7		5 to 7		5 to 8	
Expected forfeiture rate	0-10%		0-20%		0-20%	
Volatility	55%		60%		65%	

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

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

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

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

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

The Company amortizes the fair value of all stock based awards, net of estimated forfeitures, on a straight-line basis over the requisite service period, which generally is the vesting period.

A progression of activity and various other information relative to stock options for the year ended December 31, 2010 is presented in the table below.

	Common Shares	Weighted- Average Exercise Price	Aggregate Intrinsic Value
Outstanding beginning of period	2,465,750	\$ 2.87	
Granted	341,500	4.07	
Exercised	(259,650)	2.07	
Expired	(69,500)	8.02	
Forfeited	(52,100)	2.71	
Outstanding end of period	2,426,000	\$ 2.98	\$ 12,299,238
Exercisable at end of period	1,527,200	\$ 2.83	\$ 7,694,660

The aggregate intrinsic value in the table above represents the total difference between the Company's closing stock price on December 31, 2010 (the last trading day of the year) of \$8.04 and the option exercise price, multiplied by the number of in-the-money options as of December 31, 2010. As of December 31, 2010, total unrecognized compensation expense related to non-vested stock options was \$950,377, net of estimated forfeitures, with a weighted average expense recognition period of 2.2 years. The weighted average remaining contractual term of options

outstanding at December 31, 2010 was 4.3 years. Options exercisable at December 31, 2010 have a weighted average remaining contractual term of 3.2 years.

**Table of Contents****HEALTHSTREAM, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****12. STOCK BASED COMPENSATION (continued)**

Other information relative to option activity during the years ended December 31, 2010, 2009, and 2008 is as follows:

	<b>Year Ended December 31,</b>		
	<b>2010</b>	<b>2009</b>	<b>2008</b>
Weighted average grant date fair value of stock options granted	\$ 2.15	\$ 1.17	\$ 1.69
Total fair value of stock options vested	\$ 587,599	\$ 531,104	\$ 629,528
Total intrinsic value of stock options exercised	\$ 637,760	\$ 547,628	\$ 61,617
Cash proceeds from exercise of stock options	\$ 536,332	\$ 425,354	\$ 210,928

**13. EMPLOYEE BENEFIT PLAN****401(k) Plan**

The Company has a defined-contribution employee benefit plan (401(k) Plan) incorporating provisions of Section 401(k) of the Internal Revenue Code. Employees must have attained the age of 21 and have completed thirty days of service to be eligible to participate in the 401(k) Plan. Under the provisions of the 401(k) Plan, a plan member may make contributions, on a tax-deferred basis, not to exceed 20% of compensation, subject to IRS limitations. The Company has not provided matching contributions through December 31, 2010.

**14. DEBT**

At December 31, 2010 and 2009, the Company had the following debt outstanding:

	<b>December 31,</b>	
	<b>2010</b>	<b>2009</b>
Promissory Note	\$	\$ 306,942
Less current portion		(306,942)
Long-term debt (net of current portion)	\$	\$

**Promissory Note**

During 2007, the Company financed the purchase of approximately \$2.1 million in multi-year software licenses. As a result of this transaction, the Company entered into a promissory note loan agreement which was scheduled to be repaid in 36 payments due on a monthly basis beginning July 1, 2007. The promissory note included interest at an annual rate of 2.32%, and was unsecured. The promissory note was paid in full during 2010.

**Revolving Credit Facility**

The Company maintains a Loan Agreement (the Revolving Credit Facility ) with SunTrust Bank ( SunTrust ) in the aggregate principal amount of \$15.0 million, which matures on July 21, 2011. The obligations under the revolving credit facility are guaranteed by each of the Company's subsidiaries. The Company's borrowings under the revolving credit facility bear interest at the 30-Day LIBOR Rate plus a margin of either 190 or 220 basis points determined in accordance with a pricing grid, but has a minimum interest rate of not less than three percent. Principal is payable in full on the maturity date. The Company is required to pay a commitment fee of 25 basis points per annum of the average daily unused portion of the revolving credit facility.

The purpose of the revolving credit facility is for general working capital needs, permitted acquisitions (as defined in the Loan Agreement), and for stock repurchase and/or redemption transactions that the Company may authorize. The revolving credit facility contains certain covenants that, among other things, restrict additional indebtedness, liens and encumbrances, changes to the character of the Company's business, acquisitions, asset dispositions, mergers and

consolidations, sale or discount of receivables, creation or acquisitions of additional subsidiaries, and other matters customarily restricted in such agreements.

**Table of Contents****HEALTHSTREAM, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****14. DEBT (continued)**

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

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

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

tangible net worth may not be less than \$1.00

As of December 31, 2010, the Company believes it was in compliance with all covenants. There were no balances outstanding on the revolving credit facility as of December 31, 2010.

**15. LEASES**

As of December 31, 2010, the Company leased office facilities in Nashville, TN and Laurel, MD under agreements that expire before or during April 2017. Some lease agreements contain provisions for escalating rent payments over the initial terms of the lease. The Company accounts for these leases by recognizing rent expense on a straight-line basis and adjusting the deferred rent expense liability for the difference between the straight-line rent expense and the amount of rent paid. The Company also leases certain office equipment under operating leases. Total rent expense under all operating leases was approximately \$1,756,000, \$1,467,000, and \$1,502,000, for the years ended December 31, 2010, 2009, and 2008, respectively. The Company also leases office equipment from third parties which are accounted for as capital leases.

Future rental payment commitments at December 31, 2010 under capital and non-cancelable operating leases, with initial terms of one year or more, are as follows:

	<b>Capital Leases</b>	<b>Operating Leases</b>
2011	\$ 4,494	\$ 1,456,183
2012		885,589
2013		768,011
2014		752,557
2015		764,741
Thereafter		1,036,384
Total minimum lease payments	4,494	\$ 5,663,465
Less amounts representing interest	(132)	
Present value of minimum lease payments	\$ 4,362	

The carrying value of assets under capital leases, which are included with owned assets in the accompanying consolidated balance sheets, was \$-0- and \$7,500 at December 31, 2010 and 2009, respectively. Amortization of the assets under the capital leases is included in depreciation expense on the accompanying consolidated statements of income.

**16. LITIGATION**

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



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**Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure**

None.

**Item 9A. Controls and Procedures**

**Evaluation of Disclosure Controls and Procedures**

HealthStream's chief executive officer and principal financial officer have reviewed and evaluated the effectiveness of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) promulgated under the Securities Exchange Act of 1934 (the Exchange Act)) as of December 31, 2010. Based on that evaluation, the chief executive officer and principal financial officer have concluded that HealthStream's disclosure controls and procedures were effective to ensure that the information required to be disclosed by the Company in the reports the Company files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and the information required to be disclosed in the reports the Company files or submits under the Exchange Act was accumulated and communicated to the Company's management, including its principal executive and principal financial officer, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

**Management's Report On Internal Control Over Financial Reporting**

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

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

Management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2010. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control-Integrated Framework. Management's assessment included an evaluation of the design of our internal control over financial reporting and testing of the operational effectiveness of our internal control over financial reporting. Management believes that, as of December 31, 2010, the Company's internal control over financial reporting was effective based on those criteria. This annual report does not include an attestation report of the Company's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the Company's registered public accounting firm pursuant to temporary rules of the Securities and Exchange Commission that permit the Company to provide only management's report in this annual report.

**Changes in Internal Control Over Financial Reporting**

There were no changes in HealthStream's internal control over financial reporting that occurred during the fourth quarter of 2010 that have materially affected, or that are reasonably likely to materially affect, HealthStream's internal control over financial reporting.

**Item 9B. Other Information**

None.



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**PART III**

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

Information as to directors of the Company and corporate governance is incorporated by reference from the information contained in our proxy statement for the 2011 Annual Meeting of Shareholders that we will file with the Securities and Exchange Commission within 120 days of the end of the fiscal year to which this report relates. Pursuant to General Instruction G(3), certain information concerning executive officers of the Company is included in Part I of this Form 10-K, under the caption Executive Officers of the Registrant.

**Item 11. *Executive Compensation***

Incorporated by reference from the information contained in our proxy statement for the 2011 Annual Meeting of Shareholders that we will file with the Securities and Exchange Commission within 120 days of the end of the fiscal year to which this report relates.

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

Incorporated by reference from the information contained in our proxy statement for the 2011 Annual Meeting of Shareholders that we will file with the Securities and Exchange Commission within 120 days of the end of the fiscal year to which this report relates.

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

Incorporated by reference from the information contained in our proxy statement for the 2011 Annual Meeting of Shareholders that we will file with the Securities and Exchange Commission within 120 days of the end of the fiscal year to which this report relates.

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

Incorporated by reference from the information contained in our proxy statement for the 2011 Annual Meeting of Shareholders that we will file with the Securities and Exchange Commission within 120 days of the end of the fiscal year to which this report relates.

**Table of Contents****PART IV****Item 15. Exhibits, Financial Statement Schedules**

(a)(1) Financial Statements Reference is made to the financial statements included in Item 8 to this Report on Form 10-K.

(a)(2) Financial Statement Schedules

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

(a)(3) Exhibits

<b>Number</b>	<b>Description</b>
2.1 <sup>(1)</sup>	Stock Purchase Agreement, dated as of March 28, 2005, by and among HealthStream, Inc., Mel B. Thompson and Data Management & Research, Inc.
2.2 <sup>(2)</sup>	Stock Purchase Agreement, dated as of March 12, 2007, by and among HealthStream, Inc., The Jackson Organization, Research Consultants, Inc., David Jackson and the Jackson Charitable Remainder Trust
*3.1	Form of Fourth Amended and Restated Charter of HealthStream, Inc.
*3.2	Form of Amended and Restated Bylaws of HealthStream, Inc.
*4.1	Form of certificate representing the common stock, no par value per share, of HealthStream, Inc.
4.2	Reference is made to Exhibits 3.1 and 3.2.
*10.1 <sup>^</sup>	1994 Employee Stock Option Plan, effective as of April 15, 1994
*10.2 <sup>^</sup>	2000 Stock Incentive Plan, effective as of April 10, 2000
*10.3 <sup>^(9)</sup>	2010 Stock Incentive Plan, effective as of May 27, 2010
*10.4 <sup>^</sup>	Form of Indemnification Agreement
*10.5 <sup>^(3)</sup>	Executive Employment Agreement, dated July 21, 2005, between HealthStream, Inc. and Robert A. Frist, Jr.
*10.6	Lease dated March 27, 1995, as amended June 6, 1995 and September 22, 1998, between Cummins Station LLC, as landlord, and NewOrder Media, Inc., as tenant
<sup>^</sup> 10.7 <sup>(4)</sup>	Form of HealthStream, Inc. Non-Qualified Stock Option Agreement (Employees)
<sup>^</sup> 10.8 <sup>(4)</sup>	Form of HealthStream, Inc. Incentive Stock Option Agreement (Employees)
<sup>^</sup> 10.9 <sup>(4)</sup>	Form of HealthStream, Inc. Non-Qualified Stock Option Agreement (Directors)
10.10 <sup>(5)</sup>	Loan Agreement dated July 21, 2006 between HealthStream, Inc. and SunTrust Bank
10.11 <sup>(6)</sup>	First Amendment to Loan Agreement dated February 16, 2007 between HealthStream, Inc. and SunTrust Bank

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- 10.12 <sup>(7)</sup> Second Amendment to Loan Agreement dated July 23, 2007 between HealthStream, Inc. and SunTrust Bank
- 10.13 <sup>(8)</sup> Third Amendment to Loan Agreement dated July 17, 2009 between HealthStream, Inc. and SunTrust Bank
- <sup>^</sup>10.14 Summary of Director and Executive Officer Compensation
- 21.1 Subsidiaries of HealthStream, Inc.
- 23.1 Consent of Independent Registered Public Accounting Firm
- 31.1 Certification of the Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification of the Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2 Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

\* Incorporated by reference to Registrant's Registration Statement on Form S-1, as amended (Reg. No. 333-88939).

<sup>^</sup> Management contract or compensatory plan or arrangement

- (1) Incorporated by reference from exhibit filed on our Current Report on Form 8-K, dated March 29, 2005.
- (2) Incorporated by reference from exhibit filed on our Current Report on Form 8-K, dated March 12, 2007.
- (3) Incorporated by reference from exhibit filed on our Current Report on Form 8-K, dated July 25, 2005.
- (4) Incorporated by reference from exhibit filed on our Current Report on Form 8-K, dated June 1, 2010.
- (5) Incorporated by reference from exhibit filed on our Current Report on Form 8-K, dated July 25, 2006.
- (6) Incorporated by reference from exhibit filed on our Current Report on Form 8-K, dated February 20, 2007.
- (7) Incorporated by reference from exhibit filed on our Current Report on Form 8-K, dated July 24, 2007.
- (8) Incorporated by reference from exhibit filed on our Current Report on Form 8-K, dated July 17, 2009.
- (9) Incorporated by reference to Appendix B of the Company's Definitive Proxy Statement filed with the SEC on April 29, 2010.

**Table of Contents****SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized on this 23rd day of March, 2011.

HEALTHSTREAM, INC.

By: /s/ Robert A. Frist, Jr.  
Robert A. Frist, Jr.  
*Chief Executive Officer*

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

<b>Signature</b>	<b>Title(s)</b>	<b>Date</b>
/s/ Robert A. Frist, Jr. Robert A. Frist, Jr.	President, Chief Executive Officer and Chairman (Principal Executive Officer)	March 23, 2011
/s/ Gerard M. Hayden, Jr. Gerard M. Hayden, Jr.	Chief Financial Officer and Senior Vice President (Principal Financial and Accounting Officer)	March 23, 2011
Thompson Dent	Director	
/s/ Frank Gordon Frank Gordon	Director	March 23, 2011
/s/ C. Martin Harris C. Martin Harris	Director	March 23, 2011
/s/ Jeffrey L. McLaren Jeffrey L. McLaren	Director	March 23, 2011
/s/ Dale Polley Dale Polley	Director	March 23, 2011
/s/ Linda Rebrovick Linda Rebrovick	Director	March 23, 2011
/s/ Michael Shmerling	Director	March 23, 2011

Michael Shmerling

/s/ William Stead

Director

March 23, 2011

William Stead

/s/ Deborah Taylor Tate

Director

March 23, 2011

Deborah Taylor Tate

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