HEALTHSTREAM INC
Form 10-K
March 30, 2007

Table of Contents

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-K

þ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
FOR THE FISCAL YEAR ENDED DECEMBER 31, 2006
OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
FOR THE TRANSITION PERIOD FROM TO
Commission File Number 000-27701
HEALTHSTREAM, INC.
(Exact name of registrant as specified in its charter)

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

(615) 301-3100
(Registrant s telephone number, including area code)
Securities Registered Pursuant To Section 12(b) Of The Act:

Title of each class	Name of each Exchange on which registered
Common Stock, No Par Value	NASDAQ Global Stock Market

Securities Registered Pursuant To Section 12(g) Of The Act: None

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

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

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

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

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

Large accelerated filer o Accelerated filer o Non-accelerated filer þ

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

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 National Market on June 30, 2006 was

$60,129,214. 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 26, 2007, there were 22,182,056 shares of the Registrant s common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant s definitive Proxy Statement for its 2007 Annual Meeting of Shareholders are incorporated by reference into Part III hereof.

HEALTHSTREAM, INC.
TABLE OF CONTENTS
ANNUAL REPORT ON FORM 10-K

Table of Contents

PART I

This Annual Report 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 negative 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 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 to meet the training, information, and education needs of the healthcare industry. Our learning products are used by healthcare organizations to meet a broad range of their training and assessment needs, while our research products provide our customers information about patients experiences, workforce challenges, physician relations, and community perceptions of their services. HealthStream s customers are healthcare organizations (HCO) and pharmaceutical and medical device companies (PMD) and include over 1,400 healthcare organizations (predominately acute-care facilities) throughout the United States and some of the top medical device and pharmaceutical companies.

The Company s flagship learning product is the HealthStream Learning Center® (HLC), our proprietary, Internet-based learning platform, which at December 31, 2006 had approximately 1,452,000 contracted hospital-based subscribers. We deliver educational and training courseware to our customers through the HLC platform. Our research products were added as a result of our acquisition of Data Management & Research, Inc. (DMR) in March 2005, which expanded our service offering to include quality and satisfaction surveys, data analyses of survey results, and other research-based measurement tools focused on physicians, patients, employees, and members of the community. Services provided to and on behalf of pharmaceutical and medical device companies are focused on the development and delivery of education initiatives to reach hospital-based healthcare professionals, including physicians, and industry sales representatives. Our products and services include live and online education and training activities as well as Internet-based medical device training within hospitals through our HospitalDirect® platform. Pharmaceutical and medical device companies provide commercial support for some of our continuing education activities.

Headquartered in Nashville, Tennessee, the Company was incorporated in 1990 and began marketing its Internet-based solutions in March 1999. Including satellite offices in Denver, Colorado and Franklin, Tennessee, HealthStream had approximately 160 employees as of December 31, 2006. From an initial focus on technology-based training, HealthStream has evolved to provide full-service delivery of training, information and education to healthcare organizations. The Company completed its initial public offering (IPO) in April of 2000.

RECENT DEVELOPMENTS

On March 12, 2007, the Company acquired all of the issued and outstanding common stock of The Jackson Organization, Research Consultants, Inc. (TJO) for approximately $12.6 million, consisting of approximately $11.6 million payable in cash and 252,616 shares of HealthStream common stock. Approximately $5.0 million of the cash consideration is being held in escrow and will be released upon the occurrence of future events. All of the common stock shares are held in an escrow account until eighteen months after March 12, 2007, and are subject to any claims for indemnification pursuant to the stock purchase agreement. The Company expects direct, incremental expenses associated with the acquisition of TJO will approximate $0.7 million. TJO provides healthcare organizations with quality and satisfaction surveys, data analyses of survey results, and other research-based measurement tools. TJO is based in Laurel, Maryland and employs approximately 200 full time and part time employees.

Table of Contents

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 $2.0 trillion in 2005, or 16.0 percent of the gross domestic product. Hospital care expenditures accounted for nearly 31 percent of the $2.0 trillion industry. Approximately 10.4 million professionals are employed in the healthcare segment of the domestic economy, with more than 5.0 million employed in hospitals, our target market for the HealthStream Learning Center, HealthStreamDirect , and HealthStream s survey and research products.

The five million hospital-based healthcare professionals that work in the nation s approximately 5,000 acute-care hospitals are each 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 on Accreditation of Healthcare Organizations (JCAHO), 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 enhanced workforce development as well as additional competency based training. The American College of Healthcare Executives reported in October 2004 that 72% of hospital CEO s were experiencing nursing shortages at their facilities. According to U.S. Bureau of Labor Statistics (February 2004) Monthly Labor Review, more than one million new and replacement nurses will be needed by 2012. For the first time, the U.S. Department of Labor has identified Registered Nursing as the top occupation in terms of job growth through the year 2012. 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 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. They 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, determine the status of physician relations and 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 Health Plan Survey) Hospital Survey launched by CMS in partnership with the Agency for Healthcare Research and Quality (AHRQ). According to the Deficit Reduction Act of 2005, hospitals must now submit data for all required quality measures which 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, beginning in July 2007, will incur a reduction of two percentage points in payment rates in 2008. Through both DMR and TJO, we have been designated as a certified vendor, and will continue to 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

Services to healthcare organizations

HealthStream s solutions help healthcare organizations meet their ongoing training, education, information, and compliance needs. 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 . This combination 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, 2006, 1,452,000 healthcare professionals had contracted subscriptions for our 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.

Our platform and our courseware are hosted in a central data center that allows subscribers Internet access to our services, thereby eliminating the need for onsite local implementations of installed learning management products. A significant number of our customers that historically used our installed learning management products have transitioned to our Internet-based platform. Although we no longer sell our installed learning management products, we continue to maintain a legacy installed product and we provide certain customers ongoing maintenance and support, product updates, and have developed technology to provide them with additional courseware access capabilities. Our installed learning management software contracts historically consisted of an upfront license fee, additional courseware sales, and ongoing maintenance and support.

We began offering our research and survey products as a result of our acquisition of DMR, which occurred on March 28, 2005. On March 12, 2007, we acquired TJO, expanding both our customer base and product strengths. The addition of the research businesses supplemented our existing product and service offerings to include physician, patient, community, and employee satisfaction surveys, data analyses of survey results, and other research-based measurement tools. These acquisitions expanded our product offerings to 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 incorporate the results into training and improvement through our learning products. As a result of these acquisitions we maintain offices in Franklin, Tennessee and Laurel, Maryland.

Along with the Internet-based HLC, we also offer healthcare organizations full-service capabilities to convert 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, with a separate fee for development licenses.

We are currently developing an updated product that will allow us to offer our customers tools to assess competency and performance. Competency assessment is a requirement of hospitals and healthcare organizations for maintaining accreditation, based on JCAHO requirements to evaluate, document, and report performance competencies. We anticipate that our new product will provide an effective means of determining which competencies are associated with each position and evaluating and documenting competency assessments. This new product is also intended to facilitate the development of a custom training program of courses available through the HLC that uniquely responds to the needs identified for each employee.

Our strategy is to continue to grow our customer base of approximately 1,452,000 contracted subscribers using the Internet-based HLC, as well as expanding penetration of additional tools and content across our customer base. We will continue to expand our offering of research and information tools that are aligned with healthcare quality initiatives and continuous improvement efforts. We continue to transition our installed learning management product customers to our Internet-based HLC platform; however historical transitions have resulted in a smaller installed product customer base. We believe our sales force and market conditions offer us the opportunity to continue to grow our hospital-based customer base.

Services to pharmaceutical and medical device companies

Our services to pharmaceutical companies and medical device companies are focused on development, management, and distribution of education activities for three audiences: provider-based healthcare professionals, physicians, and the companies own sales representatives. We develop, manage and distribute live, online and 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 learners completing them. Live education and training activities include live single or multi-day workshops, preceptorships and proctorships, and activities presented in hospitals by clinical representatives. Online education and training activities include courseware containing video, animations and simulations and live web meetings. Print education and training activities include study guides. All of these activities are supported by either pharmaceutical or medical device companies.

Pricing for all services is based on the scope of the activity, and is attributed to several categories of services including: activity design and development, accreditation, marketing, faculty and meeting coordination, maintenance and distribution, project management, and replication and fulfillment. Not all categories of services apply to all activities. The most significant exceptions to this pricing approach are distribution and management fees which are based on the number of facilities or users reached and fees for certain courseware for sales representatives, which is priced on a per user basis. Fees for non-accredited activities are paid by pharmaceutical and medical device companies as ordinary service fees. Fees for accredited activities are paid in the form of unrestricted educational grants.

Our services for pharmaceutical and medical device companies are coordinated by our project management and clinical education personnel. We employ a team of project managers and clinical education managers and outsource most other services to third-party individuals and companies. The most significant exceptions to our outsourcing approach are the distribution and management of activities, particularly online activities that take advantage of our learning management platform and customer network. Project managers control all aspects of the development of activities and manage third-party resources used on their projects. Clinical education managers control all aspects of the content of accredited activities.

Our strategy includes expanding our revenues by further developing customer relationships and by leveraging our existing base of Internet-based HLC customers for deployment of pharmaceutical and medical device training and education through both existing products as well as development of new products. We seek to grow our pharmaceutical and medical device business, but will focus on transitioning many of our service offerings to Internet-based products and reducing our focus on project-based development services.

Table of Contents

BUSINESS COMBINATIONS

We acquired TJO on March 12, 2007. For additional information regarding this acquisition, please refer to the Company s Current Report on Form 8-K, as filed by the Company with the Securities and Exchange Commission on March 13, 2007.

We acquired DMR in March 2005. For additional information regarding this acquisition, please see Note 2 of the Consolidated Financial Statements and Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations included elsewhere in this report.

CUSTOMERS

We provide our training, information and education 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 derived approximately 11% and 14% of net revenue from HCA, Inc. during 2006 and 2005, respectively. During both 2006 and 2005, no other customers represented more than 10% of our net revenue.

The following is a partial list of customers that have purchased or contracted for products and services from HealthStream.

Healthcare Organizations	**Pharmaceutical and Medical Device Companies**
HCA, Inc.	Zimmer Holdings, Inc.
Tenet Healthcare Corporation	Smith & Nephew, Inc.
Community Health Systems, Inc.	Baxter Healthcare Corporation
Lifepoint Hospitals, Inc.	
Ardent Health Services, LLC	
Health Management Associates, Inc.	

SALES, MARKETING, AND CUSTOMER SUPPORT

We market our products and services primarily through our direct sales force and our account relationship managers. As of December 31, 2006, our sales and relationship management personnel consisted of approximately 39 employees based at our corporate headquarters in Nashville, Tennessee and in our satellite offices located in Franklin, Tennessee and Denver, Colorado, as well as remote home office sales locations. Our geographically dispersed field sales organization is divided into teams focused on our hospital audience and our pharmaceutical and medical device audience. In addition to sales professionals, we also employ strategic account personnel that manage our largest customer relationships as well as account relationship managers who work to develop and expand relationships, including contract renewals, with our hospital customers.

We conduct a variety of marketing programs to promote our products and services, including product catalogs, user groups and trade shows, online promotion and demonstrations, telemarketing campaigns, public relations, distribution of product specific literature, direct mail and advertising. Annually, we host a national users group in Nashville known as The Summit. We have an in-house marketing team that is responsible for these initiatives and for working with, and supporting, our product managers and sales force. We also have an in-house research team focused on ensuring that our sales professionals have appropriate market and target information.

We believe our ability to establish and maintain long-term customer relationships, adoption of our products and services and recurring sales are dependent on the strength of our customer service, operations, training, and support team. As of December 31, 2006, our customer service, operations, training, and support team consisted of approximately 41 employees located in our corporate headquarters in Nashville as well as our Franklin, Tennessee office. This team provides customer support to end users through a toll-free telephone line as well as electronic mail. Our representatives are trained to understand our philosophy, our products and services, and our specific sales, marketing and support issues. This team also maintains an ongoing dialog with our customer base to ensure a complete understanding of customer needs. These personnel also assist with ongoing issues and training associated with our products as well as to ensure anticipated renewals and incremental sales are achieved. The remaining personnel on this team are responsible for training, implementation and support of HLC, HealthStream Express, our survey business, and installed learning management customers.

TECHNOLOGY MANAGEMENT

Our services are designed to be secure, reliable, and expandable. Our software is a combination of proprietary and commercially-available software and operating systems. This combination of software supports acquisition and conversion of content, hosting and management of that content, publication of our Web sites, downloads of courseware, registration, tracking of users, and reporting of information for both internal and external use. We designed 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 network infrastructure, Web sites, and servers that deliver most of our services are hosted by third party providers. Our primary data center and hosting facility is in Chicago, while a second data center and hosting facility is located in Nashville (with a separate vendor). Our second hosting facility has been utilized to support product and platform testing by customers, but we continue to work to configure

Table of Contents

this location as a backup facility. Both providers maintain our equipment in a secure environment, including multiple redundancies in power sources and network connections. Our providers hosting centers are connected to the Internet through multiple, redundant high-speed fiber optic circuits. Our survey products are hosted on servers located at our Franklin, Tennessee and Laurel, Maryland offices. Company personnel monitor all servers, networks, and systems on a continuous basis. Together with our providers, we employ several levels of enterprise firewall systems to protect our databases, customer information, and courseware library. Backups of customer data are performed on a daily basis. Data is secured at a remote location on a weekly basis.

COMPETITION

The healthcare education industry is highly fragmented, varies significantly in delivery methods (*i.e.*, written materials, live events, satellite broadcasts, video, CD-ROM products 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 related results of these traditional methods, both from a business and compliance standpoint, are difficult to track and measure.

In addition to the competing delivery methods described above, we also have direct competitors. A number of companies offer competitive installed and Web based learning management products to the healthcare industry. We also compete with learning management system providers such as SABA 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 Thomson Delmar Net Learning and Reed Elsevier MC Strategies. In the survey business, we see competition from Press Ganey, National Research Corporation, and Gallup. Finally, recently we have also seen an increase in a teaming approach between consulting and technology entities to address larger scale projects.

We believe our solutions, which include both products and services that facilitate training for healthcare professionals, a wide assortment of courseware, a mechanism for measuring satisfaction or other results, and the ability to provide all our services on a single platform over the Internet, provide us with a competitive advantage. We believe that the principal competitive factors affecting the marketing of information, training and development services 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, scalability, and the ability to track utilization and results;
- scope and variety of Internet-based learning courseware available, including mandated content for OSHA, JCAHO, 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;
- 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 improving the quality and accessibility of healthcare training.

Table of Contents

GOVERNMENT REGULATION OF THE INTERNET AND THE HEALTHCARE INDUSTRY

The Internet

The laws and regulations that govern our business change rapidly. 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 Law. Current and proposed federal, state and foreign privacy regulations and other laws restricting the collection, use, confidentiality and disclosure of personal information could limit our ability to collect information or use 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.

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.

Information Security Accountability Regulation. At least six bills are pending in Congress that could require public companies to obtain certification by an independent third party of the company s computer information security. In addition, California has enacted legislation requiring disclosure of security breaches involving personal information, and legislation has been proposed in at least fifteen other states. If this legislation is enacted, we may incur costs to comply with these security requirements. The preliminary nature of such legislation and the lack of related guidance make estimation of related costs difficult. If the Company is required to make a public announcement regarding a breach of security, it could have a negative impact on our business.

Sales and Use Tax. Through December 31, 2006, 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 and Internet communications 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

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. These requirements vary by state and depend on the classification of the employee.

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.

Joint Commission on Accreditation of Healthcare Organizations (JCAHO). JCAHO mandates that employers in the healthcare industry provide certain workplace safety and patient interaction training to employees. JCAHO required training 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 JCAHO accreditation. In addition, JCAHO 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.

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-one 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.

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.

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. Thirty-six state medical licensing boards currently have CME requirements. 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 by multiple entities 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 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. 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.

Consumer Assessment of Healthcare Providers and Systems (CAHPS). The Centers for Medicare and Medicaid Services (CMS) have partnered with the Agency for Healthcare Research and Quality (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 perspective 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. According to the Deficit Reduction Act of 2005, hospitals must now submit data for all required quality measures which 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, beginning in July 2007, will incur a reduction of 2.0 percentage points in payment rates in 2008. Through both DMR and TJO, we have received certified vendor designation, and will continue to offer CAHPS® Hospital Survey services.

Office of the Inspector General (OIG) of the Department of Health and Human Services (HHS)

The 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). This document includes guidelines related to continuing educational activities supported by pharmaceutical and medical device companies. The Guidelines could affect the type and extent of future support 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. The AMA has established its own code of ethics regarding Gifts to Physician 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.

During 2006, both the ANCC and ACPE adopted ACCME Standards of Commercial Support. Because of the adoption of the ACCME Standards, rules governing the individuals that may deliver educational activities (including clinical education activities and live events) and the location of educational activities at live events are more restricted. Further, ACCME, ANCC, and ACPE are currently collaborating to develop a Unified Self Study Report. This will allow an organization that has been awarded an accreditation status or is seeking accreditation status with all three accrediting bodies the ability to complete one self study application and process. We believe this will also streamline the reaccreditation timeline for accredited organizations. Until this Unified Report is completed, we will not be able to analyze the Report s impact on our accredited education activities.

The U.S. Food and Drug Administration and the Federal Trade Commission

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 1996, the FDA announced it would develop a guidance document expressing a broad set of policies dealing with the promotion of pharmaceutical, biotechnology and medical device products on the Internet. The FDA has yet to issue that guidance document, and it is not clear when such document may be released. The FDA guidance document may reflect new regulatory policies that more tightly regulate the format and content of promotional information on the Internet.

Other Government Regulations

The U.S. Securities and Exchange Commission (the SEC) chartered the Advisory Committee on Smaller Public Companies (the Committee) on March 23, 2005. The charter directed the Committee to assess the current regulatory system for smaller public companies, including the impact of the Sarbanes-Oxley Act of 2002, and make recommendations for change. Currently, our compliance with Section 404 of the Sarbanes-Oxley Act has been deferred to calendar year 2007. During April 2006, the Committee issued its final report to the SEC, which included a recommendation to establish a system of scaled securities regulations for smaller public companies. The Committee also made specific recommendations with regard to the external audit requirement under Section 404 of the Sarbanes-Oxley Act. The compliance environment in which we operate continues to evolve. The Company continues to monitor the resolution of this issue to ensure that we appropriately allocate our resources to maintain compliance with all applicable regulations.

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 by controlling 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 , QUALITY CHECK , and RESULTS! On-demand survey analysis.

We obtain the courseware that we license to our customers 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, 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 liability we might sustain due to the content they provide.

If a third party asserts a claim that we have infringed their 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 rights may not be adequate. Third parties may infringe or misappropriate our proprietary rights. Competitors may also independently develop technologies that are substantially equivalent or superior to the technologies we employ in our 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 450 Fifth Street, NW, 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. 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, 2006, we employed approximately 160 persons. 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:

Name	Age	Position
Robert A. Frist, Jr.	39	Chief Executive Officer, President and Chairman of the Board of Directors
Arthur E. Newman	58	Executive Vice President, Compliance Officer
Susan A. Brownie	42	Senior Vice President and Chief Financial Officer, Corporate Secretary
J. Edward Pearson	44	Senior Vice President
Kevin P. O Hara	37	Senior Vice President and General Counsel

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 graduated with a Bachelor of Science in business with concentrations in finance, economics and marketing from Trinity University.

Arthur E. Newman was promoted to executive vice president effective in March 2006. Mr. Newman previously served as our chief financial officer and senior vice president since joining the Company in January 2000. Mr. Newman also serves as our compliance officer. From April 1990 to August 1999, Mr. Newman served as executive vice president overseeing finance, human resources, information systems and customer service and fulfillment for Lippincott, Williams and Wilkins, formerly Waverly, Inc., a publicly traded medical sciences publisher. From August 1999 to January 2000, Mr. Newman served as the chief technology officer for Wolters Kluwer s scientific, technical and medical companies consisting of five separate units. Mr. Newman holds a Bachelor of Science in chemistry from the University of Miami and a Masters of Business Administration from Rutgers University.

Susan A. Brownie was promoted to chief financial officer effective in March 2006 and was promoted to senior vice president in January 2005. Ms. Brownie previously served as our vice president of finance and corporate controller since joining us in November 1999. Ms. Brownie also serves as our corporate secretary. Ms. Brownie serves on the board of directors of Levy s Inc., a clothing retailer. She holds a Bachelor of Business Administration from the College of William and Mary and is a certified public accountant.

J. Edward Pearson joined the company in June 2006 as senior vice president, responsible for our survey and research business. Effective with the acquisition of TJO on March 12, 2007, Mr. Pearson was named president of the newly formed HealthStream Research group. From 2002 to June 2003, Mr. Pearson served as CEO for Medibuy, an internet-based healthcare exchange and supply chain efficiency solutions provider. 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 Science in accounting from Middle Tennessee State University.

Kevin P. O Hara was promoted to senior vice president and general counsel in February 2007. Mr. O Hara was promoted to vice president in 2005, and has served in various roles since joining us in January 2002. Mr. O Hara served as vice president of operations and development at smallbusiness.com from 2000 to 2001. He practiced as an attorney with Bass, Berry, & Sims LLC in Nashville, Tennessee from 1996 to 2000, with a specialty in technology, electronic commerce, and healthcare. He earned a Bachelor of Arts degree and a J.D. from Vanderbilt 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 implement 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, transitioning existing customers, further penetration and additional sales to existing customers and introductions of new products and services. Some of the risks that we may encounter in implementing our growth strategy include:

- expenses, delays and difficulties of identifying and integrating new products or services into our existing organization;
- inability to leverage our operational and financial systems sufficient to support our growth;
- inability to generate sufficient revenue from new products to offset investment costs; and
- inability to effectively identify, manage and exploit existing and emerging market opportunities.

If any of these risks are realized, our business could suffer.

We may be unable to effectively identify, complete or integrate the operations of TJO and future acquisitions.

As part of our growth strategy, we are actively reviewing possible acquisitions that complement or enhance our business. We may not be able to identify, complete or integrate the operations of future acquisitions, including the integration of our recent acquisition of TJO. In addition, if we finance acquisitions 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 strategy include:

- expenses, delays or difficulties of identifying and integrating acquired companies into our organization;
- inability to retain personnel associated with acquisitions;
- diversion of management s attention from daily operations; and
- inability to generate sufficient revenues from acquisitions to offset acquisition costs.

Certain revenue components are subject to significant fluctuations.

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 associated with our project based products and services, which generally relates to healthcare organization customers who use our survey and research services as well as our pharmaceutical and medical device customers. Our survey and research services are typically contracted by healthcare organizations for multi-year terms, but the frequency and timing of survey cycles can vary from quarter to quarter. The pharmaceutical and medical device business is generally associated with recurring customer relationships; however services are generally specific and relate to product launches or training events that may vary from year to year. The magnitude of such contracts may vary widely.

Our sales cycle is lengthy and can vary widely.

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 factors including an increasing trend towards more formal requests for proposals (RFP s) process, and more competition within our industry, as well as formal budget timelines which impact timing of purchases by target customers. 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 predict quarterly financial performance.

Table of Contents

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

Several of our competitors have longer operating histories and significantly greater financial, technical, marketing, and other resources than we do. We encounter direct competition from both large and small e-learning companies focused on training and continuing education in the healthcare industry. We also face competition from larger survey and research companies. We believe we maintain a competitive advantage against our competitors with the comprehensive array of products and services we offer. If our competitors were to offer a complete e-learning solution to the healthcare industry, our competitive position could be adversely affected. These companies may be able to respond more quickly than we are to new or changing opportunities, technologies, standards or customer requirements. Further, most of our customer agreements are for shorter terms ranging from one to three years, with no obligation to renew. The short terms of these agreements allow customers to more easily shift to one of our competitors.

Growth in courseware subscription revenues depend, in part, on our obtaining proper distribution rights from our content partners.

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 and decreased revenues. Most of our agreements with our content partners are also non-exclusive, and our competitors also offer, or could offer, training and continuing education content that is similar to or the same as ours. If publishers and authors, including our current content partners, offer information to users or our competitors on more favorable terms than those offered to us or increase our license fees, our competitive position and our profit margins and prospects could be harmed. In addition, the failure by our content partners to deliver high-quality content and to revise their content in response to user demand and evolving healthcare advances and trends could result in user dissatisfaction and inhibit our ability to attract and retain subscribers of our courseware offerings.

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

Our revenue growth is expected to be generated 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 or adoption of new methodology by new customers. Because healthcare training continues to change and evolve, we may be unable to accurately predict and develop features, content and other products to address the needs of the healthcare industry. 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 business 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.

Within the healthcare industry, our customer channels are focused on two segments: healthcare organizations and pharmaceutical/ medical device companies. We rely on spending within these two segments and our business may suffer if financial pressures cause our potential or existing customers to cut back on our services.

There are several economic factors that have had an impact on the nation s approximately 5,000 acute care hospitals. Some of these factors include labor costs, which as recently as 2002 constituted 40 percent of 2002 hospital revenues, according to the Centers for Medicare and Medicaid (CMS), with half of that allocated for staffing nurses. Also, the reduced Medicare payment increases that resulted from the Balanced Budget Act of 1997 and the lower payments that most hospitals accepted from managed care companies in the last several years have both had an adverse financial effect on the hospital segment. These financial pressures, along with several major hospital defaults and bankruptcies, have resulted in limited access to capital for some hospitals. As HealthStream s target market within the healthcare industry, hospitals financial pressures are salient in achieving our business objectives.

Financial analysts generally believe that medical device companies enjoy higher revenues and earnings growth, relative to their medical supply company counterparts, although they re considered more volatile. The medical device industry is highly concentrated; the largest two percent of the 6,000 U.S. medical device firms account for nearly half of the industry s sales, according to the CMS. In addition, relatively short product life cycles for medical devices make the management and marketing strategies particularly crucial in this segment. These economic factors contribute to the volatility of this customer channel for HealthStream.

The top ten pharmaceutical companies account for 60 percent of U.S. drug sales, with the top company owning a ten percent market share of the U.S. pharmaceutical market in 2001, according to CMS. Successful research and development is the key driver for long-term growth, yet this may be held constant or reduced during profit crunches like that experienced by some companies as the patent expires on their blockbuster drugs. Both branded and generic pharmaceutical companies fiercely litigate intellectually property and, as a result, may experience adverse financial consequences. Over the past few years, pharmaceutical companies experienced a significant increase in public scrutiny with respect to product development, testing and introductions in certain specific treatment areas. Continued restrictions or further extending the testing and product launch cycle could have a negative impact on our sales to and revenues from pharmaceutical companies. As one of our two customer channels, these characteristics of the pharmaceutical and medical device segment could have an impact on HealthStream.

Our product and service offerings include third party technology, the loss of which could materially harm our business. Errors in third party software or our inability to license this software in the future could increase our costs and decrease our revenues.

We use some licensed third party technology components in 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 technology licenses could result in delays in the introduction of new products or could force us to discontinue offering portions of our learning management 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 software 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 provide our Internet-based training and education services and our survey and research services to HCA, Inc. (HCA) under separate agreements. During 2006, we derived approximately 11%, or $3.5 million, of our net revenues from HCA. Our agreement with HCA for our Internet-based training and education services was renewed for a four year term effective October 1, 2006, and includes the option for HCA to renew for an additional year. Our survey and research services agreement with HCA expires in December 2007. We also derive a significant portion of our revenues from a relatively small number of other customers. A termination of our agreements with HCA or several of our other significant customers or a failure by HCA or other significant 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 more significant impact on our revenue and operating results.

For the year ended December 31, 2006, approximately 59 percent of our net revenues were 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 initial subscription period, 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, 2006, we renewed 90% of the annual contract value up for renewal and 96% of the subscribers which were up for renewal. Because a significant portion of our customer contracts have only renewed one time, 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 their dissatisfaction with our service. If we are unable to renew a substantial portion of the contracts that are up for renewal or maintain our pricing, our revenues could be adversely affected, which would have a material adverse affect on our results of operations and financial position. Contracts for our survey and research services typically range from one to three years in length, and customers are not obligated to renew their contract with us after their contract expires. In addition, much of our live event activity is of a recurring and somewhat predictable nature; however, we do not have any long term contracts that obligate these customers beyond their current contract terms. 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. Our future success also depends in part on our ability to sell additional features or enhanced offerings of our services to our current customers. This may require increasingly sophisticated and costly sales efforts that require targeting, contact with, or approval by our customer s senior management. If these efforts are not successful, our business may suffer.

Table of Contents

The timing of our revenue recognition from sales activity is dependent upon achievement of certain events or performance milestones, and our inability to accurately predict them will harm our operating results.

Our ability to record revenues 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 revenues 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 utilization of courseware is required in connection with subscription Internet-based learning products and commercial support arrangements for us to recognize revenues. As we noted above, while we have been successful in achieving growth in our subscription based revenues, our project based revenues have and may continue to be subject to significant fluctuations.

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 a large portion of our revenue from customers monthly over the terms of their subscription agreements, which are typically 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 subscriptions 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 these reduced revenues. 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.

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.

Our current cash reserves, revolving credit facility, and results of operations are expected to be sufficient to meet our cash requirements through at least 2007. 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;
- sustain content and development relationships; or
- acquire complementary businesses, technology, content or products.

At December 31, 2006, we had approximately $12.8 million in cash, cash equivalents, restricted cash, investments in marketable securities and related interest receivable. We also have up to $10.0 million of availability under a revolving credit facility, subject to certain covenants. During March 2007, we acquired TJO for approximately $11.6 million in cash. We expect to incur up to $5.0 million of capital expenditures, software feature enhancements and content purchases during 2007 to support our business. We continue to actively review possible business acquisitions that would complement our products and services. We may not have adequate cash and investments or availability under our revolving credit facility to consummate one or more acquisitions. 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 shareholders may be reduced.

Our relatively short operating history may prevent us from forecasting our results of operations accurately.

As a result of our relatively short operating history and lack of sustained success in executing our growth strategy, we do not have historical financial data for a significant number of periods upon which to forecast quarterly revenues and results of operations. We believe that period-to-period comparisons of our operating results are not necessarily meaningful and should not be relied upon as indicators of future performance. In addition, our operating results may vary substantially. This variability may be the result of differences in levels of sales activity, introductions of new products and services, and the related revenue recognition for our various products and services. In one or more future quarters, our results of operations may fall below recent operating trends or the expectations of securities analysts and investors, and the trading price of our common stock may decline.

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, 2006, our balance sheet included goodwill of $10.3 million and identifiable intangible assets of $2.8 million. The acquisition of TJO in March 2007 will increase these amounts ranging between approximately $13.0 million to $15.0 million. Economic, legal, regulatory, competitive, contractual, and other factors may affect the carrying value of goodwill and identifiable intangible assets in the future. If any of these factors impair the value of these assets, accounting rules require us to reduce their carrying value and recognize an impairment charge, which would reduce our reported assets and earnings in the period 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, some 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 as to our future financial performance; changes in market valuations of other online service companies; future sales of our common stock; stock market price and volume 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 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.

Risks Related to Sales, Marketing and Competition

We continue to refine our pricing and our products and services and cannot predict whether the ongoing changes will be accepted.

Over the past few years we have implemented several changes and 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

Difficulties in the release and transition to the new version of our Internet-based HLC platform could harm our business.

We released a new version of our Internet-based HLC platform during the fourth quarter of 2006 and as of February 28, 2007, we have transitioned approximately one-half of our HLC subscriber base to this platform. Our future success will depend on our ability to successfully transition all of our customers to the new platform. We have experienced issues with certain customers that have transitioned to the new platform such as defects in the software, data migration errors, and customer orientation to certain changed or new features. If we are unable to timely correct these issues with certain customers that have already transitioned to the new platform or we experience similar issues with those customers that are yet to transition, customers may become dissatified with our services. If this happens, we could lose customers or experience increased expenses as a result of accelerated remediation efforts or provision of product and service credits in excess of our accrual for service interruptions.

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 and learning management systems on both a subscription and transactional basis over the Internet. Our future success will depend on our ability to effectively develop 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 revenues could be adversely affected, which would have a material adverse effect on our financial condition.

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

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

Table of Contents

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 grow as we expect or maintain the quality of our services.

Our future success will depend on our ability to attract, train, retain and motivate other highly skilled technical, managerial, marketing and customer support personnel. Competition for these 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, which is where our headquarters are located. We will need to maintain 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.

We must continue to upgrade our technology infrastructure, both hardware and software, to effectively meet demand for our services.

We must continue to add hardware and enhance 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 and reduce future revenues.

Our network infrastructure and computer systems and software may fail.

An unexpected event like 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. 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 revenues if our security measures fail.

If the security measures that we use to protect personal information are ineffective, we may lose users of our services, which could reduce our revenues. We rely on security and authentication technology licensed from third parties. With this t