

HEALTHSTREAM INC
Form 10-Q
August 01, 2011

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

**Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended June 30, 2011
Commission File No.: 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**

37203

(Address of principal executive offices)

(Zip Code)

(615) 301-3100

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See 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 Exchange Act). Yes No

As of July 28, 2011, 22,118,685 shares of the registrant's common stock were outstanding.

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HEALTHSTREAM, INC.**

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HEALTHSTREAM, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS

| | June 30, 2011 (Unaudited) | December 31, 2010 |
|---|--|------------------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 24,447,300 | \$ 17,867,860 |
| Investments in short-term marketable securities | 2,011,564 | 5,703,192 |
| Restricted cash | 1,380 | 84,528 |
| Interest receivable | 48,870 | 51,226 |
| Accounts receivable, net of allowance for doubtful accounts of \$146,686 and \$156,723 at June 30, 2011 and December 31, 2010, respectively | 12,594,657 | 11,069,108 |
| Accounts receivable unbilled | 1,202,532 | 1,314,025 |
| Deferred tax assets, current | 3,436,671 | 3,436,671 |
| Prepaid royalties, net of amortization | 2,059,751 | 3,145,297 |
| Other prepaid expenses and other current assets | 1,799,378 | 1,598,874 |
| Total current assets | 47,602,103 | 44,270,781 |
| Property and equipment: | | |
| Equipment | 14,958,043 | 14,347,683 |
| Leasehold improvements | 3,713,470 | 2,737,715 |
| Furniture and fixtures | 2,096,734 | 2,027,535 |
| | 20,768,247 | 19,112,933 |
| Less accumulated depreciation and amortization | (15,857,115) | (15,287,579) |
| | 4,911,132 | 3,825,354 |
| Capitalized software development, net of accumulated amortization of \$6,995,727 and \$5,886,594 at June 30, 2011 and December 31, 2010, respectively | 7,843,957 | 4,332,705 |
| Goodwill | 21,146,864 | 21,146,864 |
| Intangible assets, net of accumulated amortization of \$8,494,185 and \$8,043,328 at June 30, 2011 and December 31, 2010, respectively | 2,392,957 | 2,843,814 |
| Deferred tax assets, noncurrent | 3,274,474 | 5,346,536 |
| Other assets | 137,401 | 244,649 |
| Total assets | \$ 87,308,888 | \$ 82,010,703 |
| LIABILITIES AND SHAREHOLDERS EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 727,628 | \$ 2,374,621 |
| Accrued liabilities | 3,879,348 | 4,120,786 |
| Accrued compensation and related expenses | 1,225,007 | 1,506,245 |

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| | | |
|--|---------------|---------------|
| Deferred revenue | 19,913,709 | 16,740,454 |
| Capital lease obligations | 2,210 | 4,362 |
| Total current liabilities | 25,747,902 | 24,746,468 |
| Other long-term liabilities | 476,779 | 473,897 |
| Commitments and contingencies | | |
| Shareholders' equity: | | |
| Common stock, no par value, 75,000,000 shares authorized; 22,061,685 and 21,805,235 shares issued and outstanding at June 30, 2011 and December 31, 2010, respectively | 98,160,825 | 97,227,198 |
| Accumulated deficit | (37,075,264) | (40,431,443) |
| Accumulated other comprehensive loss | (1,354) | (5,417) |
| Total shareholders' equity | 61,084,207 | 56,790,338 |
| Total liabilities and shareholders' equity | \$ 87,308,888 | \$ 82,010,703 |

See accompanying notes to the condensed consolidated financial statements.

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HEALTHSTREAM, INC.
CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

| | Three Months Ended June 30, | |
|--|------------------------------------|---------------|
| | 2011 | 2010 |
| Revenues, net | \$ 21,050,859 | \$ 16,660,469 |
| Operating costs and expenses: | | |
| Cost of revenues (excluding depreciation and amortization) | 7,638,306 | 5,906,377 |
| Product development | 1,911,233 | 1,722,929 |
| Sales and marketing | 4,356,488 | 3,049,817 |
| Other general and administrative expenses | 2,684,318 | 2,398,065 |
| Depreciation and amortization | 1,354,683 | 1,235,918 |
| Total operating costs and expenses | 17,945,028 | 14,313,106 |
| Income from operations | 3,105,831 | 2,347,363 |
| Other income (expense): | | |
| Interest and other income | 8,638 | 5,784 |
| Interest and other expense | (12,796) | (10,101) |
| Total other expense, net | (4,158) | (4,317) |
| Income before income tax provision | 3,101,673 | 2,343,046 |
| Income tax provision | 1,271,251 | 995,337 |
| Net income | \$ 1,830,422 | \$ 1,347,709 |
| Net income per share: | | |
| Basic | \$ 0.08 | \$ 0.06 |
| Diluted | \$ 0.08 | \$ 0.06 |
| Weighted average shares of common stock outstanding: | | |
| Basic | 22,001,911 | 21,795,558 |
| Diluted | 23,350,247 | 22,432,931 |

See accompanying notes to the condensed consolidated financial statements.

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HEALTHSTREAM, INC.
CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

| | Six Months Ended June 30, | |
|--|----------------------------------|---------------|
| | 2011 | 2010 |
| Revenues, net | \$ 39,556,594 | \$ 31,497,721 |
| Operating costs and expenses: | | |
| Cost of revenues (excluding depreciation and amortization) | 14,708,094 | 11,368,360 |
| Product development | 3,697,481 | 3,249,094 |
| Sales and marketing | 7,864,132 | 6,010,686 |
| Other general and administrative expenses | 5,226,489 | 4,483,934 |
| Depreciation and amortization | 2,397,557 | 2,626,260 |
| Total operating costs and expenses | 33,893,753 | 27,738,334 |
| Income from operations | 5,662,841 | 3,759,387 |
| Other income (expense): | | |
| Interest and other income | 38,165 | 8,499 |
| Interest and other expense | (22,165) | (21,317) |
| Total other income (expense), net | 16,000 | (12,818) |
| Income before income tax provision | 5,678,841 | 3,746,569 |
| Income tax provision | 2,322,662 | 1,591,996 |
| Net income | \$ 3,356,179 | \$ 2,154,573 |
| Net income per share: | | |
| Basic | \$ 0.15 | \$ 0.10 |
| Diluted | \$ 0.14 | \$ 0.10 |
| Weighted average shares of common stock outstanding: | | |
| Basic | 21,919,622 | 21,735,661 |
| Diluted | 23,159,827 | 22,281,538 |

See accompanying notes to the condensed consolidated financial statements.

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HEALTHSTREAM, INC.
CONDENSED CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY (UNAUDITED)
SIX MONTHS ENDED JUNE 30, 2011

| | Common Stock | | Accumulated | Accumulated Other Comprehensive Income | Total Shareholders |
|---|--------------|---------------|-----------------|---|-----------------------|
| | Shares | Amount | Deficit | (Loss) | Equity |
| Balance at December 31, 2010 | 21,805,235 | \$ 97,227,198 | \$ (40,431,443) | \$ (5,417) | \$ 56,790,338 |
| Net income | | | 3,356,179 | | 3,356,179 |
| Unrealized gain on investments in marketable securities | | | | 4,063 | 4,063 |
| Stock based compensation expense | | 373,829 | | | 373,829 |
| Exercise of stock options | 256,450 | 559,798 | | | 559,798 |
| Balance at June 30, 2011 | 22,061,685 | \$ 98,160,825 | \$ (37,075,264) | \$ (1,354) | \$ 61,084,207 |

See accompanying notes to the condensed consolidated financial statements.

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HEALTHSTREAM, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

| | Six Months Ended June 30, | 2011 | 2010 |
|---|----------------------------------|---------------|---------------|
| OPERATING ACTIVITIES: | | | |
| Net income | \$ | 3,356,179 | \$ 2,154,573 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Depreciation and amortization | | 2,397,557 | 2,626,260 |
| Stock based compensation expense | | 373,829 | 332,550 |
| Deferred income taxes | | 2,072,062 | 1,591,996 |
| Provision for doubtful accounts | | 20,000 | |
| Changes in operating assets and liabilities: | | | |
| Accounts and unbilled receivables | (1,434,056) | | (366,881) |
| Restricted cash | | 83,148 | 29,281 |
| Prepaid royalties | | 1,085,546 | 610,328 |
| Other prepaid expenses and other current assets | (313,631) | | (480,018) |
| Other assets | | 179,878 | 93,740 |
| Accounts payable | (1,646,993) | | (1,012,814) |
| Accrued liabilities and accrued compensation and related expenses and other long-term liabilities | | (519,794) | (874,796) |
| Deferred revenue | | 3,173,255 | 3,189,759 |
| Net cash provided by operating activities | | 8,826,980 | 7,893,978 |
| INVESTING ACTIVITIES: | | | |
| Proceeds from maturities of investments in marketable securities | | 8,350,868 | |
| Purchases of investments in marketable securities | | (4,727,704) | |
| Payments associated with capitalized software development | | (4,620,385) | (1,021,710) |
| Purchases of property and equipment | | (1,807,965) | (509,947) |
| Net cash used in investing activities | | (2,805,186) | (1,531,657) |
| FINANCING ACTIVITIES: | | | |
| Proceeds from exercise of stock options | | 559,798 | 435,050 |
| Payments on note payable | | | (306,942) |
| Payments on capital lease obligations | | (2,152) | (5,837) |
| Net cash provided by financing activities | | 557,646 | 122,271 |
| Net increase in cash and cash equivalents | | 6,579,440 | 6,484,592 |
| Cash and cash equivalents at beginning of period | | 17,867,860 | 12,287,059 |
| Cash and cash equivalents at end of period | | \$ 24,447,300 | \$ 18,771,651 |

See accompanying notes to the condensed consolidated financial statements.

Table of Contents**HEALTHSTREAM, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****1. BASIS OF PRESENTATION**

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (US GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, condensed consolidated financial statements do not include all of the information and footnotes required by US GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. All significant intercompany transactions have been eliminated in consolidation. Operating results for the three and six months ended June 30, 2011 are not necessarily indicative of the results that may be expected for the year ending December 31, 2011.

The balance sheet at December 31, 2010 is consistent with the audited financial statements at that date but does not include all of the information and footnotes required by US GAAP for a complete set of financial statements. For further information, refer to the consolidated financial statements and footnotes thereto for the year ended December 31, 2010 (included in the Company's Annual Report on Form 10-K, filed with the Securities and Exchange Commission on March 23, 2011).

2. 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. During the six months ended June 30, 2011 and 2010, the Company recorded a provision for income taxes of \$2,322,662 and \$1,591,996, respectively. The Company's effective tax rate for the six months ended June 30, 2011 and 2010 was 41.0% and 42.5%, respectively. The Company's effective tax rate primarily reflects the statutory corporate income tax rate, the net effect of state taxes, and the effect of various immaterial permanent tax differences.

3. STOCK BASED COMPENSATION

The Company maintains two stock incentive plans. The Company accounts for its stock based compensation plans using the fair-value based method for costs related to share-based payments, including stock options. During the six months ended June 30, 2011, the Company granted 354,750 stock options with a weighted average grant date fair value of \$4.66. During the six months ended June 30, 2010, the Company granted 319,000 stock options with a weighted average grant date fair value of \$2.07. The fair value of stock based awards granted during the six months ended June 30, 2011 and 2010 was estimated using the Black Scholes option pricing model, with the assumptions as follows:

| | Six Months Ended June 30, | |
|--------------------------|------------------------------|--------------|
| | 2011 | 2010 |
| Risk-free interest rate | 2.37 - 2.39% | 2.39 - 2.49% |
| Expected dividend yield | 0.0% | 0.0% |
| Expected life | 5 - 7 years | 5 - 7 years |
| Expected forfeiture rate | 0-5% | 0-10% |
| Volatility | 50% | 55% |

Total stock based compensation expense recorded for the three and six months ended June 30, 2011 and 2010, which is recorded in the condensed consolidated statements of income, is as follows:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|--------------------------------|----------|------------------------------|-----------|
| | 2011 | 2010 | 2011 | 2010 |
| Cost of revenues (excluding depreciation and amortization) | \$ 8,744 | \$ 9,634 | \$ 19,910 | \$ 18,768 |

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| | | | | |
|--|------------|------------|------------|------------|
| Product development | 36,783 | 31,865 | 76,346 | 63,952 |
| Sales and marketing | 34,261 | 42,274 | 82,197 | 86,052 |
| Other general and administrative | 104,247 | 85,997 | 195,376 | 163,778 |
| Total stock based compensation expense | \$ 184,035 | \$ 169,770 | \$ 373,829 | \$ 332,550 |

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Table of Contents**HEALTHSTREAM, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****4. 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 only to the extent these shares are dilutive. Common equivalent shares are dilutive when the average market price during the period exceeds the exercise price of the underlying shares. The total number of common equivalent shares excluded from the calculations of diluted net income per share, due to their anti-dilutive effect, was approximately 0.4 million for both the three and six months ended June 30, 2011, and approximately 0.4 million and 0.6 million for the three and six months ended June 30, 2010, respectively.

The following table sets forth the computation of basic and diluted net income per share for the three and six months ended June 30, 2011 and 2010:

| | Three Months Ended | | Six Months Ended | |
|--------------------------------------|--------------------|--------------|------------------|--------------|
| | June 30, | | June 30, | |
| | 2011 | 2010 | 2011 | 2010 |
| Numerator: | | | | |
| Net income | \$ 1,830,422 | \$ 1,347,709 | \$ 3,356,179 | \$ 2,154,573 |
| Denominator: | | | | |
| Weighted average shares outstanding: | | | | |
| Basic | 22,001,911 | 21,795,558 | 21,919,622 | 21,735,661 |
| Employee stock options | 1,348,336 | 637,373 | 1,240,205 | 545,877 |
| Diluted | 23,350,247 | 22,432,931 | 23,159,827 | 22,281,538 |
| Net income per share: | | | | |
| Basic | \$ 0.08 | \$ 0.06 | \$ 0.15 | \$ 0.10 |
| Diluted | \$ 0.08 | \$ 0.06 | \$ 0.14 | \$ 0.10 |

5. COLLABORATIVE ARRANGEMENT

On June 23, 2010, the Company announced the formation of SimVentures, a collaborative arrangement between HealthStream and Laerdal Medical Corporation (Laerdal Medical). The Company receives 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 accounts for SimVentures as a collaborative arrangement in accordance with applicable accounting guidance. During the first quarter of 2011, the Company acquired fifty percent ownership in Laerdal Medical's Advanced Video System (AVS) product for \$3.5 million in cash. AVS is a product that enables users of advanced patient simulators to easily capture video, audio, data logs, and patient responses. The AVS product is now jointly owned through SimVentures. During the second quarter of 2011, SimVentures launched SimStore, one of the components of SimCenter that offers healthcare providers an opportunity to sample and purchase simulation scenarios to use in their simulation training activities. During the six months ended June 30, 2011, the Company recorded approximately \$148,000 of revenues and \$498,000 of expenses related to the collaborative arrangement. The expenses are primarily recorded in the product development, sales and marketing and depreciation and amortization

categories within the condensed consolidated statements of income. The Company also recorded approximately \$3.9 million of capitalized software development for SimVentures during 2011, comprised of the \$3.5 million paid for the AVS product and \$392,000 associated with SimStore™.

6. BUSINESS SEGMENTS

The Company primarily provides services to healthcare organizations, and to a lesser extent, to pharmaceutical and medical device companies and other members within the healthcare industry. The Company's 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). The accounting policies of the segments are the same as those described in the summary of significant accounting policies in the Company's Annual Report on Form 10-K for the year ended December 31, 2010.

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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 following is the Company's business segment information as of and for the three and six months ended June 30, 2011 and 2010.

| | Three Months Ended | | Six Months Ended | |
|------------------------------|--------------------|---------------|------------------|----------------------|
| | June 30, | | June 30, | |
| | 2011 | 2010 | 2011 | 2010 |
| Revenues | | | | |
| HealthStream Learning | \$ 14,455,535 | \$ 11,239,362 | \$ 27,442,483 | \$ 21,542,266 |
| HealthStream Research | 6,595,324 | 5,421,107 | 12,114,111 | 9,955,455 |
| Total net revenue | \$ 21,050,859 | \$ 16,660,469 | \$ 39,556,594 | \$ 31,497,721 |
| Income from operations | | | | |
| HealthStream Learning | \$ 4,209,044 | \$ 3,947,747 | \$ 8,475,578 | \$ 7,168,092 |
| HealthStream Research | 1,145,505 | 465,853 | 1,472,519 | 625,424 |
| Unallocated | (2,248,718) | (2,066,237) | (4,285,256) | (4,034,129) |
| Total income from operations | \$ 3,105,831 | \$ 2,347,363 | \$ 5,662,841 | \$ 3,759,387 |
| | | | June 30, 2011 | December 31, 2010 |
| Segment assets * | | | | |
| HealthStream Learning | | | \$ 23,200,454 | \$ 18,730,859 |
| HealthStream Research | | | 25,669,354 | 26,701,566 |
| Unallocated | | | 38,439,080 | 36,578,278 |
| Total assets | | | \$ 87,308,888 | \$ 82,010,703 |

* Segment assets include restricted cash, accounts and unbilled receivables, prepaid and other current assets, other assets, capitalized software development, 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.

7. INVESTMENTS IN MARKETABLE SECURITIES

At June 30, 2011, the fair value of investments in marketable securities, which were all classified as current and available-for-sale, included the following:

| | Amortized | | Unrealized | Fair Value |
|---------------------------|--------------|------------|------------|--------------|
| | Cost | Losses | | |
| Corporate debt securities | \$ 2,012,918 | \$ (1,354) | | \$ 2,011,564 |

The above debt securities at June 30, 2011 mature within one year.

8. FAIR VALUE OF FINANCIAL INSTRUMENTS

The assets and liabilities that are measured at fair value on a recurring basis as of June 30, 2011 were as follows:

| | Level 1 | Level 2 | Level 3 |
|--------------------------------------|----------------|----------------|----------------|
| Investments in marketable securities | \$ 2,011,564 | \$ | \$ |

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

At June 30, 2011 and 2010, the Company did not have any financial liabilities that were subject to fair value measurements.

Table of Contents**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**
Special Cautionary Notice Regarding Forward-Looking Statements

You should read the following discussion and analysis in conjunction with our condensed consolidated financial statements and related notes included elsewhere in this report and our audited consolidated financial statements and the notes thereto for the year ended December 31, 2010, appearing in our Annual Report on Form 10-K that was filed with the Securities and Exchange Commission (SEC) on March 23, 2011 (the 2010 Form 10-K). Statements contained in this Quarterly Report on Form 10-Q that are not historical fact are forward-looking statements that the Company intends to be covered by the safe harbor provisions for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995. Statements that are predictive in nature, that depend on or refer to future events or conditions, or that include words such as anticipates, believes, could, estimates, expects, intends, may, predicts, projects, should, will, would, and similar expressions are forward-looking statements. The Company cautions that forward-looking statements involve known and unknown risks, uncertainties, and other factors that may cause actual results, performance, or achievements to be materially different from any future results, performance, or achievements expressed or implied by the forward-looking statements. Forward-looking statements reflect our current views with respect to future events and are based on assumptions and subject to risks and uncertainties. Given these uncertainties, you should not place undue reliance on these forward-looking statements. In evaluating any forward-looking statement, you should specifically consider the information regarding forward-looking statements and the information set forth under the caption Item 1A. Risk Factors in our 2010 Form 10-K and the information regarding forward-looking statements in our earnings releases, as well as other cautionary statements contained elsewhere in this report, including the matters discussed in Critical Accounting Policies and Estimates. We undertake no obligation beyond that required by law to update publicly any forward-looking statements for any reason, even if new information becomes available or other events occur in the future. You should read this report and the documents that we reference in this report and have filed as exhibits to this report completely and with the understanding that our actual future results may be materially different from what we expect.

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® (HLC), authoring tools, courseware subscriptions, implementation and consulting services, content development, online sales training courses (RepDirect), HospitalDire® 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 patients, employees, physicians, and members of the community.

Key financial and operational indicators for the second quarter of 2011 include:

Revenues of \$21.1 million in the second quarter of 2011, up 26% over the second quarter of 2010

Operating income of \$3.1 million in the second quarter of 2011, up 32% over the second quarter of 2010

Net income of \$1.8 million, up 36% from net income of \$1.3 million in the second quarter of 2010, and earnings per share (EPS) of \$0.08 per share in the second quarter of 2011, up 30% from EPS of \$0.06 per share in the second quarter of 2010

Adjusted EBITDA of \$4.6 million in the second quarter of 2011, up 24% from \$3.8 million in the second quarter of 2010

Critical Accounting Policies and Estimates

Our condensed consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States (US GAAP). These accounting principles require us to make certain estimates, judgments and assumptions during the preparation of our financial statements. We believe the estimates, judgments and assumptions upon which we rely are reasonable based upon information available to us at the time they are made. These estimates, judgments and assumptions can affect the reported amounts of assets and liabilities as of the date of the financial statements, as well as the reported amounts of revenues and expenses during the periods presented. To the extent there are material differences between these estimates, judgments or assumptions and actual results, our financial statements will be affected.

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The accounting policies and estimates that we believe are the most critical in fully understanding and evaluating our reported financial results include the following:

Revenue recognition

Accounting for income taxes

Product development costs and related capitalization

Goodwill, intangibles, and other long-lived assets

Allowance for doubtful accounts

Accrual for service credits

Stock based compensation

Nonmonetary exchange of content rights and deferred service credits

In many cases, the accounting treatment of a particular transaction is specifically dictated by US GAAP and does not require management's judgment in its application. There are also areas in which management's judgment in selecting among available alternatives would not produce a materially different result. See Notes to Consolidated Financial Statements in our 2010 Form 10-K, which contains additional information regarding our accounting policies and other disclosures required by US GAAP. There have been no changes in our critical accounting policies and estimates from those reported in our 2010 Form 10-K.

Revenues and Expense Components

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

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

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

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Other Income (Expense). 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 capital leases and our revolving credit facility.

Three Months Ended June 30, 2011 Compared to Three Months Ended June 30, 2010

Revenues, net. Revenues increased approximately \$4.4 million, or 26.4%, to \$21.1 million for the three months ended June 30, 2011 from \$16.7 million for the three months ended June 30, 2010. Revenues for 2011 consisted of \$14.5 million, or 69% of total revenue, for HealthStream Learning and \$6.6 million, or 31% of total revenue, for HealthStream Research. In 2010, revenues consisted of \$11.2 million, or 68% of total revenue, for HealthStream Learning and \$5.4 million, or 32% of total revenue, for HealthStream Research.

Revenues for HealthStream Learning increased \$3.2 million, or 28.6%, over the second quarter of 2010. Revenues from our Internet-based subscription learning products increased by \$3.0 million over the prior year second quarter, and were comprised of revenue increases from the HLC of \$1.0 million and from courseware subscriptions of \$1.9 million. Revenues from our Internet-based subscription products increased 28.9% over the prior year second quarter due to a higher number of subscribers and more courseware consumption by subscribers. Our HLC subscriber base increased to 2,486,000 fully-implemented subscribers and 2,586,000 contracted subscribers at June 30, 2011 compared to 2,113,000 fully-implemented subscribers and 2,258,000 contracted subscribers at June 30, 2010.

Contracted subscribers include both those already implemented (2,486,000 and 2,113,000 at June 30, 2011 and 2010, respectively) and those in the process of implementation (100,000 and 145,000 at June 30, 2011 and 2010, respectively). Revenues from our collaborative arrangement with Laerdal Medical Corporation were approximately \$148,000 during the second quarter of 2011. Revenues for the second quarter of 2011 also include approximately \$305,000 of participant registration fees from the Summit.

Revenues for HealthStream Research increased \$1.2 million, or 21.7%, over the second quarter of 2010. Revenues from Patient Insights surveys, our survey research product that generates recurring revenues, increased by \$874,000, or 24.6%, over the prior year second quarter. Revenues from other surveys, which are conducted on annual or bi-annual cycles, increased by \$300,000, or 16.1%, over the prior year second quarter.

Cost of Revenues (excluding depreciation and amortization). Cost of revenues increased approximately \$1.7 million, or 29.3%, to \$7.6 million for the three months ended June 30, 2011 from \$5.9 million for the three months ended June 30, 2010. Cost of revenues as a percentage of revenues was 36.3% of revenues for the three months ended June 30, 2011 compared to 35.5% of revenues for the three months ended June 30, 2010. Cost of revenues for HealthStream Learning increased approximately \$1.3 million to \$4.5 million and approximated 31.4% and 28.5% of revenues for HealthStream Learning for the three months ended June 30, 2011 and 2010, respectively. The increase is primarily associated with increased royalties paid by us resulting from growth in courseware subscription revenues. Cost of revenues for HealthStream Research increased approximately \$403,000 to \$3.1 million and approximated 47.0% and 49.8% of revenues for HealthStream Research for the three months ended June 30, 2011 and 2010, respectively. The increase in amount is primarily the result of costs associated with the growth in patient survey volume over the prior year second quarter.

Product Development. Product development expenses increased approximately \$188,000, or 10.9%, to \$1.9 million for the three months ended June 30, 2011 from \$1.7 million for the three months ended June 30, 2010. Product development expenses as a percentage of revenues were 9.1% and 10.3% of revenues for the three months ended June 30, 2011 and 2010, respectively.

Product development expenses for HealthStream Learning increased approximately \$215,000 and approximated 10.7% and 11.9% of revenues for HealthStream Learning for the three months ended June 30, 2011 and 2010, respectively. The decrease as a percentage of revenue is the result of the growth in revenues over the prior year second quarter, while the increase in amount is due to additional personnel expenses associated with platform maintenance and SimVentures. Product development expenses for HealthStream Research decreased approximately \$27,000 and approximated 5.5% and 7.2% of revenues for HealthStream Research for the three months ended June 30, 2011 and 2010, respectively.

Sales and Marketing. Sales and marketing expenses, including personnel costs, increased approximately \$1.3 million, or 42.8%, to \$4.4 million for the three months ended June 30, 2011 from \$3.1 million for the three months ended

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June 30, 2010. Approximately \$627,000 of the increase resulted from the Summit, which occurred during the second quarter of 2011, but did not occur during 2010. Sales and marketing expenses approximated 20.7% and 18.3% of revenues for the three months ended June 30, 2011 and 2010, respectively.

Sales and marketing expenses for HealthStream Learning increased \$1.1 million and approximated 20.5% and 16.3% of revenues for HealthStream Learning for the three months ended June 30, 2011 and 2010, respectively. This expense increase is primarily due to the costs associated with the Summit, as well as, additional personnel and related expenses, increased marketing spending, and increased commissions associated with better sales performance compared to the prior year. Sales and marketing expenses for HealthStream Research increased approximately \$159,000, and approximated 19.2% and 20.4% of revenues for HealthStream Research for the three

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months ended June 30, 2011 and 2010, respectively. The expense increase for HealthStream Research resulted primarily from the Summit.

Other General and Administrative Expenses. Other general and administrative expenses increased approximately \$286,000, or 11.9%, to \$2.7 million for the three months ended June 30, 2011 from \$2.4 million for the three months ended June 30, 2010. Other general and administrative expenses as a percentage of revenues approximated 12.8% and 14.4% for the three months ended June 30, 2011 and 2010, respectively.

Other general and administrative expenses for HealthStream Learning increased \$104,000 over the prior year second quarter, primarily associated with increased rent expense and recruiting fees for new employees, while other general and administrative expenses for HealthStream Research decreased by \$27,000 compared to the prior year second quarter. The unallocated corporate portion of other general and administrative expenses increased \$209,000 over the prior year second quarter, primarily associated with software maintenance renewal fees, personnel expenses, professional fees, and rent expense.

Depreciation and Amortization. Depreciation and amortization increased approximately \$119,000, or 9.6%, to \$1.4 million for the three months ended June 30, 2011 from \$1.2 million for the three months ended June 30, 2010. The increase primarily resulted from amortization of capitalized software development assets within HealthStream Learning.

Other Income (Expense), net. Other expense, net was approximately \$4,000 for both the three months ended June 30, 2011 and 2010.

Provision for Income Taxes. The Company recorded a provision for income taxes of approximately \$1.3 million for the three months ended June 30, 2011 compared to \$1.0 million for the three months ended June 30, 2010. The Company's effective tax rate was 41.0% for the second quarter of 2011 compared to 42.5% for the second quarter of 2010. 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 \$25.0 million and \$20.0 million, respectively, at December 31, 2010, to offset taxable income.

Net Income. Net income increased approximately \$483,000, or 35.8%, to approximately \$1.8 million for the three months ended June 30, 2011 from \$1.3 million for the three months ended June 30, 2010. Net income per diluted share was \$0.08 per share for the three months ended June 30, 2011, compared to \$0.06 per diluted share for the three months ended June 30, 2010.

Six Months Ended June 30, 2011 Compared to Six Months Ended June 30, 2010

Revenues, net. Revenues increased approximately \$8.1 million, or 25.6%, to \$39.6 million for the six months ended June 30, 2011 from \$31.5 million for the six months ended June 30, 2010. Revenues for 2011 consisted of \$27.4 million, or 69% of total revenue, for HealthStream Learning and \$12.1 million, or 31% of total revenue, for HealthStream Research. In 2010, revenues consisted of \$21.5 million, or 68% of total revenue, for HealthStream Learning and \$10.0 million, or 32% of total revenue, for HealthStream Research.

Revenues for HealthStream Learning increased \$5.9 million, or 27.4%, over 2010. Revenues from our Internet-based subscription learning products increased by \$5.9 million over the prior year, and were comprised of revenue increases from the HLC of \$2.1 million and from courseware subscriptions of \$3.7 million. Revenues from our Internet-based subscription products increased 29.5% over the prior year due to a higher number of subscribers and more courseware consumption by subscribers.

Revenues for HealthStream Research increased \$2.2 million, or 21.7%, over 2010. Revenues from Patient Insights surveys, our survey research product that generates recurring revenues, increased by \$1.8 million, or 26.3%, over the prior year. Revenues from other surveys, which are conducted on annual or bi-annual cycles, increased by \$349,000, or 11.3 percent, over the prior year.

Cost of Revenues (excluding depreciation and amortization). Cost of revenues increased approximately \$3.3 million, or 29.4%, to \$14.7 million for the six months ended June 30, 2011 from \$11.4 million for the six months ended June 30, 2010. Cost of revenues as a percentage of revenues was 37.2% of revenues for the six months ended June 30, 2011 compared to 36.1% of revenues for the six months ended June 30, 2010. Cost of revenues for HealthStream Learning increased approximately \$2.4 million to \$8.7 million and approximated 31.7% and 29.4% of revenues for HealthStream Learning for the six months ended June 30, 2011 and 2010, respectively. The increase is primarily

associated with increased royalties paid by us resulting from growth in courseware subscription revenues. Cost of revenues for HealthStream Research increased approximately \$967,000 to \$6.0 million and approximated 49.6% and 50.7% of revenues for HealthStream Research for the six months ended June 30, 2011 and 2010, respectively. The increase in amount is primarily the result of costs associated with the growth in patient survey volume over the prior year.

Product Development. Product development expenses increased approximately \$448,000, or 13.8%, to \$3.7 million for the six months ended June 30, 2011 from \$3.2 million for the six months ended June 30, 2010. Product development expenses as a percentage of revenues were 9.3% and 10.3% of revenues for the six months ended June 30, 2011 and 2010, respectively.

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Product development expenses for HealthStream Learning increased approximately \$423,000 and approximated 10.8% and 11.8% of revenues for HealthStream Learning for the six months ended June 30, 2011 and 2010, respectively. The decrease as a percentage of revenue is the result of the growth in revenues over the prior year, while the increase in amount is due to additional personnel expenses associated with platform maintenance and SimVentures. Product development expenses for HealthStream Research increased approximately \$25,000 and approximated 6.1% and 7.1% of revenues for HealthStream Research for the six months ended June 30, 2011 and 2010, respectively. The decrease as a percentage of revenue is the result of the growth in revenues over the prior year.

Sales and Marketing. Sales and marketing expenses, including personnel costs, increased approximately \$1.9 million, or 30.8%, to \$7.9 million for the six months ended June 30, 2011 from \$6.0 million for the six months ended June 30, 2010. Approximately \$627,000 of the increase resulted from the Summit, which occurred during the second quarter of 2011, but did not occur during 2010. Sales and marketing expenses approximated 19.9% and 19.1% of revenues for the six months ended June 30, 2011 and 2010, respectively.

Sales and marketing expenses for HealthStream Learning increased \$1.5 million and approximated 19.0% and 17.4% of revenues for HealthStream Learning for the six months ended June 30, 2011 and 2010, respectively. This expense increase is primarily due to the Summit, additional personnel and related expenses, increased marketing spending, and increased commissions associated with better sales performance compared to the prior year. Sales and marketing expenses for HealthStream Research increased approximately \$333,000, and approximated 20.1% and 21.1% of revenues for HealthStream Research for the six months ended June 30, 2011 and 2010, respectively. The expense increase for HealthStream Research resulted from the Summit and additional personnel and related expenses.

Other General and Administrative Expenses. Other general and administrative expenses increased approximately \$743,000, or 16.6%, to \$5.2 million for the six months ended June 30, 2011 from \$4.5 million for the six months ended June 30, 2010. Other general and administrative expenses as a percentage of revenues approximated 13.2% and 14.2% for the six months ended June 30, 2011 and 2010, respectively.

Other general and administrative expenses for HealthStream Learning increased \$197,000 over the prior year, primarily associated with increased rent expense and recruiting costs for new employees, while other general and administrative expenses for HealthStream Research was comparable to the prior year. The unallocated corporate portion of other general and administrative expenses increased \$547,000 over the prior year, primarily associated with software maintenance renewal fees, personnel expenses, professional fees, and rent expense.

Depreciation and Amortization. Depreciation and amortization decreased approximately \$229,000, or 8.7%, to \$2.4 million for the six months ended June 30, 2011 from \$2.6 million for the six months ended June 30, 2010. The decrease primarily resulted from lower depreciation expense associated with certain assets reaching the end of their useful lives, but was partially offset by an increase from amortization of capitalized software development.

Other Income (Expense), net. Other income, net was approximately \$16,000 for the six months ended June 30, 2011 compared to a net expense of \$13,000 for the six months ended June 30, 2010. The improvement over the prior year was associated with higher interest income resulting from higher yields on cash and investments in marketable securities.

Provision for Income Taxes. The Company recorded a provision for income taxes of approximately \$2.3 million for the six months ended June 30, 2011 compared to \$1.6 million for the six months ended June 30, 2010. The Company's effective tax rate was 41.0% for 2011 compared to 42.5% 2010.

Net Income. Net income increased approximately \$1.2 million, or 55.8%, to \$3.4 million for the six months ended June 30, 2011 from \$2.2 million for the six months ended June 30, 2010. Net income per diluted share was \$0.14 per share for the six months ended June 30, 2011, compared to \$0.10 per diluted share for the six months ended June 30, 2010.

Adjusted EBITDA (which we define as net income before interest, income taxes, stock-based compensation, and depreciation and amortization) improved by 25.6% to approximately \$8.4 million for the six months ended June 30, 2011 compared to \$6.7 million for the six months ended June 30, 2010. 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.

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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

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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 2010 and 2011, actual cash income tax payments have been significantly less than the tax provision recorded in accordance with US GAAP, and income tax payments will continue to be less than the income tax provision until our existing federal and state net operating loss carryforwards have been fully utilized or have expired.

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

Income before interest, income tax provision, stock based compensation expense, depreciation and amortization, or adjusted EBITDA:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|----------------------------------|--------------------------------|--------------|------------------------------|--------------|
| | 2011 | 2010 | 2011 | 2010 |
| Net income | \$ 1,830,422 | \$ 1,347,709 | \$ 3,356,179 | \$ 2,154,573 |
| Interest income | (8,638) | (3,354) | (31,086) | (6,020) |
| Interest expense | 12,697 | 10,101 | 22,165 | 21,317 |
| Income tax provision | 1,271,251 | 995,337 | 2,322,662 | 1,591,996 |
| Stock based compensation expense | 184,035 | 169,769 | 373,829 | 332,550 |
| Depreciation and amortization | 1,354,683 | 1,235,918 | 2,397,557 | 2,626,260 |
| Adjusted EBITDA | \$ 4,644,450 | \$ 3,755,480 | \$ 8,441,306 | \$ 6,720,676 |

Liquidity and Capital Resources

Net cash provided by operating activities was approximately \$8.8 million and \$7.9 million during the six months ended June 30, 2011 and 2010, respectively. The Company's primary sources of cash were receipts generated from the sales of our products and services. Days sales outstanding (DSO) which is calculated by dividing the accounts receivable balance, excluding unbilled and other receivables, by average daily revenues for the quarter, approximated 54 days for the second quarter of 2011 compared to 53 days for the second quarter of 2010. The primary uses of cash to fund operations included 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 \$2.8 million and \$1.5 million for the six months ended June 30, 2011 and 2010, respectively. During 2011, the Company purchased \$4.7 million of investments in marketable securities, spent \$4.6 million for capitalized software development, and purchased \$1.8 million of property and equipment. Approximately \$3.5 million of the capitalized software development spending related to the acquisition of a 50 percent ownership stake in Laerdal Medical's AVS product. These uses of cash were partially offset by maturities and sales of investments in marketable securities of \$8.4 million. During 2010, the Company spent \$1.0 million for capitalized software development and purchased \$510,000 of property and equipment.

Cash provided by financing activities was approximately \$558,000 and \$122,000 for the six months ended June 30, 2011 and 2010, respectively. The primary source of cash from financing activities for 2011 and 2010 resulted from proceeds associated with the exercise of employee stock options. The primary uses of cash for 2011 related to payments under capital lease obligations, and for 2010 related to payments under a promissory note and capital lease

obligations.

Revenues increased and operating income improved over the prior year period, and our balance sheet reflects positive working capital of \$21.9 million at June 30, 2011 compared to \$19.5 million at December 31, 2010. The increase in working capital was primarily due to the cash generated from operations. The Company's primary source of liquidity is \$26.5 million of cash and cash equivalents, investments in marketable securities, restricted cash and related interest receivable. The Company also has a \$20.0 million revolving credit facility loan agreement, all of which was available at June 30, 2011.

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

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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 could have a dilutive effect on earnings per share 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.

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

The Company is exposed to market risk from changes in interest rates. The Company does not have any foreign currency exchange rate risk or commodity price risk. As of June 30, 2011, our outstanding indebtedness included approximately \$2,200 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 175 or 200 basis points determined in accordance with a pricing grid. We are also exposed to market risk with respect to our cash and investment balances. At June 30, 2011, the Company had cash and cash equivalents, investments in marketable securities, restricted cash, and related interest receivable totaling approximately \$26.5 million. Our current investment rates of return approximate 0.14%. Assuming a 0.14% rate of return on \$26.5 million, a hypothetical 10% decrease in interest rates would decrease interest income and decrease net income on an annualized basis by approximately \$3,700.

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 4. *Controls and Procedures***Evaluation of 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 the end of the period covered by this Quarterly Report. 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 chief executive and principal financial officer, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Control Over Financial Reporting

There was no change in HealthStream's internal control over financial reporting that occurred during the period covered by this Quarterly Report that has materially affected, or that is reasonably likely to materially affect, HealthStream's internal control over financial reporting.

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PART II OTHER INFORMATION

Item 6. Exhibits

(a) Exhibits

- 31.1 Certification of the Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification of the Principal 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

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SIGNATURE

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

HEALTHSTREAM, INC.

August 1, 2011

By: /s/ Gerard M. Hayden, Jr.
Gerard M. Hayden, Jr.
Chief Financial Officer

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**HEALTHSTREAM, INC.
EXHIBIT INDEX**

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