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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 September 30, 2002**

Commission File No.: 001-8833

**HealthStream, Inc.**  
(Exact name of registrant as specified in its charter)

|  |  |
|--|--|
| <p><b>Tennessee</b></p> <hr/> <p>(State or other jurisdiction of incorporation or organization)</p> <p><b>209 10th Avenue South, Suite 450</b><br/><b>Nashville, Tennessee</b></p> <hr/> <p>(Address of principal executive offices)</p> <hr/> <p style="text-align: center;">(615) 301-3100</p> <hr/> <p>(Registrant's telephone number, including area code)</p> | <p><b>62-1443555</b></p> <hr/> <p>(I.R.S. Employer Identification No.)</p> <p><b>37203</b></p> <hr/> <p>(Zip Code)</p> |
|--|--|

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes [ ] No [X]

As of November 11, 2002, 20,322,687 shares of the registrant's common stock were outstanding.

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**PART I. FINANCIAL INFORMATION**

**Item 1. Financial Statements**

**HEALTHSTREAM, INC.**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**

|   | September 30,<br>2002        | December 31,<br>2001         |
|---|------------------------------|------------------------------|
|   | (Unaudited)                  | (Note 1)                     |
| <b>ASSETS</b>   |                              |                              |
| Current assets:   |                              |                              |
| Cash and cash equivalents   | \$ 4,989,424                 | \$ 4,747,434                 |
| Investments in short term marketable securities   | 5,915,740                    | 12,701,086                   |
| Restricted cash   | 569,113                      | 520,184                      |
| Interest receivable   | 350,388                      | 537,585                      |
| Accounts receivable, net of allowance for doubtful accounts of \$270,000 at September 30, 2002 and \$288,000 at December 31, 2001, respectively                             | 4,367,072                    | 3,776,635                    |
| Accounts receivable — unbilled  | 190,146                      | 566,069                      |
| Prepaid development fees, net of amortization   | 482,641                      | 1,030,843                    |
| Other prepaid expenses and other current assets   | 540,275                      | 649,543                      |
| <br>Total current assets  | <br>17,404,799               | <br>24,529,379               |
| Property and equipment:   |                              |                              |
| Furniture and fixtures  | 934,606                      | 990,992                      |
| Equipment   | 4,268,216                    | 4,566,342                    |
| Leasehold improvements  | 1,237,275                    | 1,111,360                    |
| <br>Less accumulated depreciation and amortization  | <br>6,440,097<br>(3,471,680) | <br>6,668,694<br>(2,974,347) |
| <br>Goodwill  | <br>2,968,417<br>3,306,688   | <br>3,694,347<br>8,306,688   |
| Intangible assets, net of accumulated amortization of \$4,732,892 at September 30, 2002 and \$3,295,675 at December 31, 2001, respectively                                  | 2,129,250                    | 3,566,467                    |
| Investments in marketable securities  | 9,307,340                    | 8,709,003                    |
| Notes receivable – related party  | 233,003                      | 215,000                      |
| Other assets  | 201,089                      | 225,760                      |
| <br>Total assets  | <br>\$ 35,550,586            | <br>\$ 49,246,644            |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>   |                              |                              |
| Current liabilities:  |                              |                              |
| Accounts payable  | \$ 780,048                   | \$ 889,254                   |
| Accrued liabilities   | 1,056,969                    | 943,616                      |
| Accrued compensation and related expenses   | 840,291                      | 717,200                      |
| Registration liabilities  | 631,240                      | 633,788                      |
| Deferred revenue  | 3,662,449                    | 3,273,825                    |
| Current portion of capital lease obligations  | 78,330                       | 126,733                      |
| <br>Total current liabilities   | <br>7,049,327                | <br>6,584,416                |
| Capital lease obligations, less current portion   | 55,291                       | 118,769                      |
| Commitments and contingencies   | —                            | —                            |
| Shareholders' equity:   |                              |                              |
| Common stock, no par value, 75,000,000 shares authorized; 20,322,687 and 20,372,542 shares issued and outstanding at September 30, 2002 and December 31, 2001, respectively | 91,217,641                   | 91,275,282                   |
| Accumulated other comprehensive income  | 89,363                       | 79,240                       |
| Accumulated deficit   | (62,861,036)                 | (48,811,063)                 |
| <br>Total shareholders' equity  | <br>28,445,968               | <br>42,543,459               |
| <br>Total liabilities and shareholders' equity  | <br>\$ 35,550,586            | <br>\$ 49,246,644            |

See accompanying notes to the condensed consolidated financial statements.

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**HEALTHSTREAM, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)**

|  | Three Months Ended, September 30, |                |
|--|-----------------------------------|----------------|
|  | 2002                              | 2001           |
| Revenues, net of warrant expense of \$-0- in 2002 and \$549,077 in 2001              | \$ 4,058,407                      | \$ 3,077,708   |
| Operating costs and expenses:  |                                   |                |
| Cost of revenues   | 1,349,443                         | 1,280,563      |
| Product development  | 1,212,022                         | 1,263,250      |
| Sales and marketing  | 1,479,632                         | 1,422,508      |
| Depreciation   | 395,163                           | 464,833        |
| Amortization of goodwill   | —                                 | 1,348,356      |
| Amortization of intangibles, content fees, fixed royalties, and prepaid compensation | 685,148                           | 714,731        |
| Other general and administrative expenses  | 1,488,524                         | 1,766,680      |
| Total operating costs and expenses   | 6,609,932                         | 8,260,921      |
| Loss from operations   | (2,551,525)                       | (5,183,213)    |
| Other income (expense):  |                                   |                |
| Interest and other income  | 182,629                           | 403,664        |
| Interest and other expense   | (12,294)                          | (9,111)        |
|  | 170,335                           | 394,553        |
| Net loss   | \$ (2,381,190)                    | \$ (4,788,660) |
| Net loss per share:  |                                   |                |
| Basic and diluted net loss per share   | \$ (0.12)                         | \$ (0.24)      |
| Weighted average shares of common stock outstanding:                                 |                                   |                |
| Basic and diluted  | 20,290,435                        | 19,846,341     |

See accompanying notes to the condensed consolidated financial statements.

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**HEALTHSTREAM, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)**

|   | Nine Months Ended, September 30, |                |
|---|----------------------------------|----------------|
|   | 2002                             | 2001           |
| Revenues, net of warrant expense of \$-0- in 2002 and \$1,489,933 in 2001               | \$ 11,726,773                    | \$ 9,655,142   |
| Operating costs and expenses:   |                                  |                |
| Cost of revenues  | 4,739,142                        | 4,082,177      |
| Product development   | 3,438,059                        | 3,750,839      |
| Office consolidation charge   | —                                | 400,678        |
| Sales and marketing   | 4,698,381                        | 4,379,399      |
| Depreciation  | 1,241,616                        | 1,269,995      |
| Amortization of goodwill  | —                                | 4,028,676      |
| Amortization of intangibles, content fees, fixed royalties, and prepaid compensation    | 2,131,469                        | 2,114,495      |
| Other general and administrative expenses   | 5,116,261                        | 5,362,279      |
| Total operating costs and expenses  | 21,364,928                       | 25,388,538     |
| Loss from operations  | (9,638,155)                      | (15,733,396)   |
| Other income (expense):   |                                  |                |
| Interest and other income   | 638,704                          | 1,491,347      |
| Write-off of investment   | —                                | (99,920)       |
| Interest and other expense  | (50,522)                         | (35,982)       |
|   | 588,182                          | 1,355,445      |
| Loss before cumulative effect of a change in accounting principle                       | (9,049,973)                      | (14,377,951)   |
| Cumulative effect of a change in accounting principle                                   | (5,000,000)                      | —              |
| Net loss  | \$(14,049,973)                   | \$(14,377,951) |
| Net loss per share:   |                                  |                |
| Basic and diluted net loss before cumulative effect of a change in accounting principle | \$ (0.45)                        | \$ (0.73)      |
| Cumulative effect of a change in accounting principle                                   | (0.25)                           | —              |
| Basic and diluted net loss per share  | \$ (0.70)                        | \$ (0.73)      |
| Weighted average shares of common stock outstanding:                                    |                                  |                |
| Basic and diluted   | 20,245,961                       | 19,822,894     |

See accompanying notes to the condensed consolidated financial statements.

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**HEALTHSTREAM, INC.**  
**CONDENSED CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY (UNAUDITED)**  
**FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2002**

|  | Common Stock |              | Accumulated Deficit | Other Comprehensive Income | Total Shareholders' Equity |
|--|--------------|--------------|---------------------|----------------------------|----------------------------|
|  | Shares       | Amount       |                     |                            |                            |
| Balance at December 31, 2001   | 20,372,542   | \$91,275,282 | \$(48,811,063)      | \$79,240                   | \$ 42,543,459              |
| Net loss   |              |              | (14,049,973)        |                            | (14,049,973)               |
| Unrealized gain on investments, net of tax                             |              |              |                     | 10,123                     | 10,123                     |
| Comprehensive loss   |              |              |                     |                            | (14,039,850)               |
| Issuance of stock options to advisory boards                           | —            | 11,385       | —                   | —                          | 11,385                     |
| Issuance of common stock to Employee Stock Purchase Plan               | 35,770       | 38,005       | —                   | —                          | 38,005                     |
| Retirement of common stock in connection with EMInet escrow resolution | (85,625)     | (107,031)    | —                   | —                          | (107,031)                  |
| Balance at September 30, 2002  | 20,322,687   | \$91,217,641 | \$(62,861,036)      | \$89,363                   | \$ 28,445,968              |

See accompanying notes to the condensed consolidated financial statements.

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

|   | Nine Months Ended September 30, |                |
|---|---------------------------------|----------------|
|   | 2002                            | 2001           |
| <b>OPERATING ACTIVITIES:</b>  |                                 |                |
| Net loss  | \$(14,049,973)                  | \$(14,377,951) |
| Adjustments to reconcile net loss to net cash used in operating activities:   |                                 |                |
| Depreciation  | 1,241,616                       | 1,269,995      |
| Amortization of goodwill  | —                               | 4,028,676      |
| Amortization of intangibles, content fees, fixed royalties, and prepaid compensation  | 2,131,469                       | 2,114,495      |
| Provision for doubtful accounts   | 265,000                         | 87,000         |
| Gain on WebMD renegotiation   | —                               | (1,500,000)    |
| Office consolidation charge   | —                               | 400,678        |
| Noncash warrant expense   | —                               | 1,489,933      |
| Issuance of stock options to advisory boards  | 11,385                          | 57,319         |
| Realized loss on disposal of property & equipment   | 15,040                          | —              |
| Realized loss on investments  | —                               | 99,920         |
| Cumulative effect of a change in accounting principle   | 5,000,000                       | —              |
| Changes in operating assets and liabilities, excluding effects of acquisitions:   |                                 |                |
| Accounts and unbilled receivables   | (537,743)                       | (357,078)      |
| Restricted cash   | (48,929)                        | 261,501        |
| Interest receivable   | 187,197                         | (40,087)       |
| Prepaid development fees  | 21,719                          | (1,173,694)    |
| Other prepaid expenses and other current assets   | (5,625)                         | (530,110)      |
| Other assets  | 231,606                         | 256,541        |
| Accounts payable  | (109,206)                       | (135,225)      |
| Accrued liabilities and compensation  | 236,444                         | (473,870)      |
| Registration liabilities  | (2,548)                         | (261,501)      |
| Deferred revenue  | 388,624                         | (139,713)      |
| Net cash used in operating activities   | (5,023,924)                     | (8,923,171)    |
| <b>INVESTING ACTIVITIES:</b>  |                                 |                |
| Acquisition of companies, net of cash acquired  | —                               | (328,988)      |
| Proceeds from maturities and sale of investments in marketable securities   | 15,568,334                      | 2,733,727      |
| Purchase of investments in marketable securities  | (9,697,817)                     | (3,518,553)    |
| Issuance of note receivable – related party   | —                               | (215,000)      |
| Repayments on note receivable   | —                               | 128,119        |
| Purchase of property and equipment  | (530,727)                       | (997,050)      |
| Net cash provided by (used in) investing activities   | 5,339,790                       | (2,197,745)    |
| <b>FINANCING ACTIVITIES:</b>  |                                 |                |
| Repurchase of common stock from WebMD   | —                               | (1,981,444)    |
| Issuance of common stock to Employee Stock Purchase Plan  | 38,005                          | 56,956         |
| Proceeds from exercise of stock options   | —                               | 10,557         |
| Payments on capital lease obligations   | (111,881)                       | (265,909)      |
| Net cash used in financing activities   | (73,876)                        | (2,179,840)    |
| Net increase (decrease) in cash and cash equivalents  | 241,990                         | (13,300,756)   |
| Cash and cash equivalents at beginning of period  | 4,747,434                       | 19,830,572     |
| Cash and cash equivalents at end of period  | \$ 4,989,424                    | \$ 6,529,816   |
| Total cash and cash equivalents, restricted cash, investments in marketable securities, and accrued interest at end of period | \$ 21,132,005                   | \$ 29,061,979  |

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

|   | Nine Months Ended September 30, |            |
|---|---------------------------------|------------|
|   | 2002                            | 2001       |
| SUPPLEMENTAL CASH FLOW INFORMATION:             |                                 |            |
| Interest paid                                   | \$22,212                        | \$ 14,113  |
| Capital lease obligations incurred              | \$ —                            | \$ 83,679  |
| Effects of acquisitions:                        |                                 |            |
| Estimated fair value of assets acquired         | \$ —                            | \$ 5,000   |
| Purchase price in excess of net assets acquired | —                               | 1,036,491  |
| Estimated fair value of liabilities assumed     | —                               | (412,317)  |
| Stock issued                                    | —                               | (300,186)  |
| Cash paid                                       | \$ —                            | \$ 328,988 |

See accompanying notes to the condensed consolidated financial statements.

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### **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 for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles 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 nine months ended September 30, 2002 are not necessarily indicative of the results that may be expected for the year ending December 31, 2002.

The balance sheet at December 31, 2001 is consistent with the audited financial statements at that date but does not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. For further information, refer to the financial statements and footnotes thereto for the year ended December 31, 2001 (included in the Company's Annual Report on Form 10-K, filed with the Securities and Exchange Commission).

During 2001, we began organizing the business along two segments: 1) services provided to healthcare organizations and professionals ("HCO"), and 2) services provided to pharmaceutical and medical device companies ("PMD"). Accordingly, we began tracking financial information on a more detailed basis for these segments and resource allocation decisions and performance assessments began to be made based on the discrete financial information for these segments (See Note 5).

Services to healthcare organizations and professionals include offerings of our Internet-based learning products, licensing, maintenance and support of our installed learning management products, content subscriptions, custom content development, and a variety of online and enduring products. Services provided to pharmaceutical and medical device companies include live event, development, coordination and registration services, Web cast events, online development and training, and other education and training services.

#### **2. RECENT ACCOUNTING PRONOUNCEMENTS**

In June 2001, the Financial Accounting Standards Board ("FASB") issued SFAS No. 141, "Business Combinations," ("Statement 141") and No. 142, "Goodwill and Other Intangible Assets" ("Statement 142"). Statement 141 requires that the purchase method of accounting be used for all business combinations initiated after June 30, 2001. Statement 141 also includes guidance on the initial recognition and measurement of goodwill and other intangible assets arising from business combinations completed after June 30, 2001. We adopted Statement 141 effective July 1, 2001. The adoption of Statement 141 did not have a material effect on our consolidated financial position or results from operations.

We adopted Statement 142 effective January 1, 2002. Statement 142 provides for the elimination of amortization of intangible assets that have indefinite lives, such as goodwill, as well as a modification of the approach and timing for evaluating impairment of intangible assets. See Notes 6 and 7 to the condensed consolidated financial statements for a discussion of the impact of this Statement on our consolidated financial position and results from operations.

In August 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," ("Statement 144"). Statement 144 addresses financial accounting and reporting for the impairment of long-lived assets and for long-lived assets to be disposed of. Statement 144 supersedes Statement 121 "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of." We adopted Statement 144 effective January 1, 2002, and it did not have a material effect on our consolidated financial position or results from operations.

In June 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities," ("Statement 146"). Statement 146 addresses financial accounting and reporting for costs associated with exit or disposal activities and supercedes EITF Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)" ("Issue 94-3"). Statement 146 requires that a liability for a cost associated with an exit or disposal activity be recognized when the liability is incurred. Under Issue 94-3, a liability for an exit cost as generally defined in Issue 94-3 was recognized at the date of an entity's commitment to an exit plan. The provisions of Statement 146 are effective for exit or disposal activities that are initiated after December 31, 2002, with early application encouraged. We adopted Statement 146 effective July 1, 2002, and it did not have a material effect on our consolidated financial position or results from operations.

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**HEALTHSTREAM, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

### **3. MERGERS AND ACQUISITIONS**

*de'MEDICI Systems.* On January 26, 2001, we acquired substantially all of the assets of de'MEDICI Systems ("de'MEDICI"), a business unit of Lippincott Williams & Wilkins, Inc., for approximately \$330,000 in cash and 181,250 shares of our common stock. de'MEDICI provided computer based education and training to over 230 hospitals and healthcare organizations. The acquisition was accounted for as a purchase business combination. Identifiable intangible assets acquired consisted of customer lists and trade name of \$0.4 million and \$0.1 million, respectively, and are being amortized on a straight-line basis over three years. We also acquired goodwill of approximately \$0.6 million.

Since the pro forma impact of the de'MEDICI acquisition is not material to the results presented for 2001, no pro forma disclosures are presented in the accompanying condensed consolidated financial statements.

During the quarter ended September 30, 2002, certain stock held in escrow related to our purchase of EMINet, Inc. was distributed or otherwise retired. In connection with the resolution, 85,625 shares of our common stock were retired. The retirement was recorded based on the market value of the shares on the date of retirement.

### **4. NET LOSS PER SHARE**

Basic net loss per share is computed by dividing the net loss available to common shareholders for the period by the weighted-average number of common shares outstanding during the period. Diluted net loss per share is computed by dividing the net loss for the period by the weighted average number of common and dilutive potential common shares outstanding during the period. Potential common shares, composed of incremental common shares issuable upon the exercise of stock options and warrants, and escrowed or restricted shares are included in diluted net loss per share only when these shares are dilutive. The total number of potential common shares excluded from the calculations of diluted net loss per share, due to their anti-dilutive effect, was approximately 3,300,000 and 5,600,000 at September 30, 2002 and September 30, 2001, respectively.

### **5. BUSINESS SEGMENTS**

We have two reportable segments, healthcare organizations and professionals ("HCO") and pharmaceutical and medical device companies ("PMD"). The accounting policies of the segments are the same as those described in the summary of significant accounting policies in our Annual Report on Form 10-K for the year ended December 31, 2001. Our reportable segments are based on the markets they serve, the products and services provided to those markets, and they are each managed separately by business unit managers.

The following is our business segment information as of and for the three and nine months ended September 30, 2002 and 2001. We measure segment performance based on the operating loss before income taxes and prior to the allocation of corporate overhead expenses, interest income, interest expense, and substantially all depreciation. Segment assets for HCO were reduced by \$5.0 million during 2002 as a result of applying new accounting rules for goodwill (See Note 6).

|  | Three months ended |                    |
|--|--------------------|--------------------|
|  | September 30, 2002 | September 30, 2001 |
| <b>Revenues</b>  |                    |                    |
| HCO, net of warrant expense of \$-0- in 2002 and \$549,077 in 2001 | \$ 2,647,097       | \$ 1,812,401       |
| PMD  | 1,411,310          | 1,265,307          |
| <br>Total net revenue  | <br>\$ 4,058,407   | <br>\$ 3,077,708   |
| <b>Loss from operations</b>  |                    |                    |
| HCO  | \$ (520,874)       | \$(2,896,475)      |
| PMD  | (313,688)          | (440,905)          |
| Unallocated  | (1,716,963)        | (1,845,833)        |
| <br>Total loss from operations                                     | <br>\$(2,551,525)  | <br>\$(5,183,213)  |

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**HEALTHSTREAM, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

## **5. BUSINESS SEGMENTS (continued)**

|  | Nine months ended  |                     |
|--|--------------------|---------------------|
|  | September 30, 2002 | September 30, 2001  |
| <b>Revenues</b>  |                    |                     |
| HCO, net of warrant expense of \$-0- in 2002 and \$1,489,933 in 2001 | \$ 7,157,503       | \$ 5,510,983        |
| PMD  | 4,569,270          | 4,144,159           |
| <br>Total net revenue  | <br>\$11,726,773   | <br>\$ 9,655,142    |
| <br><b>Loss from operations</b>                                      | <br>               | <br>                |
| HCO  | \$ (3,184,127)     | \$ (9,647,090)      |
| PMD  | (1,044,782)        | (919,558)           |
| Unallocated  | (5,409,246)        | (5,166,748)         |
| <br>Total loss from operations                                       | <br>\$ (9,638,155) | <br>\$ (15,733,396) |

\* Segment assets include restricted cash, accounts and unbilled receivables, prepaid and other current assets, other assets, property & equipment, and intangible assets. Investments in marketable securities are not allocated to individual segments.

Total loss from operations for the three and nine months ended September 30, 2001 includes goodwill amortization of \$1,248,316 and \$3,739,984, respectively for HCO and \$100,040 and \$288,692, respectively for PMD. Effective January 1, 2002, goodwill amortization was discontinued as a result of adopting new accounting standards (See Note 6). The unallocated loss from operations for the nine months ended September 30, 2001 includes the one time gain of \$1.5 million associated with the renegotiation of our agreement with WebMD Corporation, formerly Healtheon/WebMD Corporation (See Note 8).

## **6. GOODWILL**

In June 2001, the Financial Accounting Standards Board (“FASB”) issued SFAS No. 142, “Goodwill and Other Intangible Assets” (“Statement 142”). We adopted Statement 142 effective January 1, 2002. Statement 142 no longer permits amortization of goodwill and intangible assets that have indefinite lives over a set period. Statement 142 modifies the approach and timing for evaluating impairment of intangible assets, and also requires that goodwill be tested for impairment annually using a fair value method. In the year of adoption, Statement 142 requires a transitional goodwill impairment evaluation be performed, which is comprised of a two-step process. The first step is a screen for potential impairment, while the second step measures the amount, if any, of impairment.

During the second quarter of 2002, we completed the transitional goodwill impairment evaluation required by Statement 142. In performing the impairment evaluation, we estimated the fair value of our reporting units using a discounted cash flows model. Upon completion of step one, our analysis indicated that goodwill for the HCO reporting unit was impaired as of January 1, 2002. As required by the Statement, if step one results in an impairment, step two must be performed in order to measure the amount of impairment. The second step compares the implied fair value of the affected reporting unit's goodwill to its carrying value. We determined the implied fair value of HCO's goodwill by allocating its fair value, as determined in step one, to its assets and liabilities in a manner similar to a purchase price allocation in accordance with SFAS No. 141, "Business Combinations." The transitional impairment loss recognized for the HCO reporting unit totaled approximately \$5.0 million, and was recorded as a cumulative effect of a change in accounting principle in our consolidated statement of operations as of January 1, 2002.

The technique used to determine the fair value of our reporting units is sensitive to estimates and assumptions associated with cash flow from operations and its growth, discount rates, and reporting unit terminal values. If these estimates or their related assumptions change in the future, we may be required to record additional impairment charges, which could adversely impact our operating results for the period in which such a determination is made. We will perform our annual impairment evaluation of goodwill during the fourth quarter of each year.

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**HEALTHSTREAM, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**6. GOODWILL (continued)**

A reconciliation of the net loss and net loss per share information for the three and nine months ended September 30, 2002 and 2001, adjusted for the provisions of Statement 142, net of the related income tax effect, follows:

|  | Three months ended    |                       |
|--|-----------------------|-----------------------|
|  | September 30,<br>2002 | September 30,<br>2001 |
| Reported net loss  | \$(2,381,190)         | \$(4,788,660)         |
| Adjusted for amortization of goodwill                              | —                     | 1,348,356             |
| Adjusted net loss  | \$(2,381,190)         | \$(3,440,304)         |
| Basic and diluted net loss per share:                              |                       |                       |
| Reported net loss per share – basic and diluted                    | \$ (0.12)             | \$ (0.24)             |
| Adjusted for amortization of goodwill                              | —                     | 0.07                  |
| Adjusted net loss per share – basic and diluted                    | \$ (0.12)             | \$ (0.17)             |
|  | Nine months ended     |                       |
|  | September 30,<br>2002 | September 30,<br>2001 |
| Reported net loss  | \$(14,049,973)        | \$(14,377,951)        |
| Adjusted for amortization of goodwill                              | —                     | 4,028,676             |
| Adjusted for cumulative effect of a change in accounting principle | 5,000,000             | —                     |
| Adjusted net loss  | \$ (9,049,973)        | \$ (10,349,275)       |
| Basic and diluted net loss per share:                              |                       |                       |
| Reported net loss per share – basic and diluted                    | \$ (0.70)             | \$ (0.73)             |
| Adjusted for amortization of goodwill                              | —                     | 0.20                  |
| Adjusted for cumulative effect of a change in accounting principle | 0.25                  | —                     |
| Adjusted net loss per share – basic and diluted                    | \$ (0.45)             | \$ (0.53)             |

The pro forma presentation above does not exclude the impact of the one time gain on renegotiation of the WebMD agreement during the nine months ended September 30, 2001 (See Note 8).

The changes in the carrying amount of goodwill for the nine months ended September 30, 2002 are as follows:

|                               | HCO          | PMD          | Total        |
|-------------------------------|--------------|--------------|--------------|
| Balance at January 1, 2002    | \$ 6,982,961 | \$ 1,323,727 | \$ 8,306,688 |
| Transitional impairment loss  | (5,000,000)  | —            | (5,000,000)  |
| Balance at September 30, 2002 | \$ 1,982,961 | \$ 1,323,727 | \$ 3,306,688 |

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### **HEALTHSTREAM, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

#### **7. INTANGIBLE ASSETS**

All intangible assets have been evaluated in accordance with Statement 142 and are considered to have finite useful lives. The intangibles are being amortized over their original useful lives, ranging from one to five years. Amortization of intangible assets was approximately \$479,000 and \$1,437,000 for the three and nine months ended September 30, 2002 and approximately \$530,000 and \$1,601,000 for the three and nine months ended September 30, 2001.

Identifiable intangible assets are comprised of the following:

|                | As of September 30, 2002 |                          |             | As of December 31, 2001 |                          |             |
|----------------|--------------------------|--------------------------|-------------|-------------------------|--------------------------|-------------|
|                | Gross Amount             | Accumulated Amortization | Net         | Gross Amount            | Accumulated Amortization | Net         |
| Content        | \$3,500,000              | \$ (2,036,112)           | \$1,463,888 | \$3,500,000             | \$ (1,311,111)           | \$2,188,889 |
| Customer lists | 2,940,000                | (2,387,221)              | 552,779     | 2,940,000               | (1,712,221)              | 1,227,779   |
| Other          | 422,142                  | (309,559)                | 112,583     | 422,142                 | (272,343)                | 149,799     |
| Total          | \$6,862,142              | \$(4,732,892)            | \$2,129,250 | \$6,862,142             | \$(3,295,675)            | \$3,566,467 |

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

|   |                    |
|---|--------------------|
| October 1, 2002 through December 31, 2002 | \$ 479,073         |
| 2003                                      | 1,139,824          |
| 2004                                      | 343,990            |
| 2005                                      | 166,363            |
| 2006                                      | —                  |
| <b>Total</b>                              | <b>\$2,129,250</b> |

#### **8. RELATIONSHIP WITH WEBMD**

In February 2000, we entered into an agreement with WebMD which provided for us to be the exclusive provider of education, continuing education and training services for healthcare organizations, healthcare professionals and healthcare workers on Web sites owned or operated by WebMD. The agreement provided for payments to WebMD of \$6.0 million per year for five years on a quarterly basis as guaranteed minimum royalties. In the first year, \$2.0 million of the \$6.0 million payment was to be applied toward mutually agreed upon branding and promotion services. Under the agreement, we were to receive 100% of any revenues from the sale of our products and services until we recovered all payments to WebMD, after which we would receive 75% and WebMD would receive 25% of any revenues.

On January 5, 2001, we terminated our prior agreement with WebMD and entered into a new business arrangement. Under the new, non-exclusive three-year agreement, we are a preferred provider of continuing medical education, continuing education and board preparation courses for WebMD's professional portal. Under this new arrangement, financial consideration is based entirely on revenues generated from the sale of HealthStream's services to WebMD's professional portal customers. The arrangement also terminated the lock-up agreement related to 1.1 million shares of our common stock that WebMD purchased in a private offering just prior to our IPO. In connection with this termination, we gave WebMD the right to sell the shares back to us at any time through March 30, 2001. On February 8, 2001, WebMD exercised its right to sell the 1.1 million shares of our common stock back to us at \$1.7833 per share. We reacquired the shares on February 16, 2001. In connection with the termination of the prior WebMD agreement, we recognized a gain of \$1.5 million representing the reversal of the scheduled \$1.5 million fixed payment that was accrued during the quarter ended September 30, 2000.

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**HEALTHSTREAM, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**9. OFFICE CONSOLIDATION CHARGE**

During the nine months ended September 30, 2001, we recorded a non recurring office consolidation charge of \$400,678 resulting from the consolidation of offices and corporate functions. The charge consisted of lease obligations of approximately \$245,000 and impairment of certain fixed assets of approximately \$155,000.

**10. CONTINGENCIES**

We are subject to various legal proceedings and claims that may arise in the ordinary course of our business. In the opinion of management, the ultimate liability with respect to those proceedings and claims will not materially affect our financial position, results from operations, or liquidity.

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

#### **Special Cautionary Notice Regarding Forward-Looking Statements**

This Quarterly Report includes various forward-looking statements that are subject to risks and uncertainties. Forward-looking statements include without limitation, statements preceded by, followed by, or that otherwise include the words "believes," "expects," "anticipates," "intends," "estimates" or similar expressions. For those statements, HealthStream, Inc. claims the protection of the safe harbor for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995.

The following important factors, in addition to those discussed elsewhere in this Quarterly Report, could affect our future financial results and could cause actual results to differ materially from those expressed in forward-looking statements contained in this document:

- our limited operating history;
- variability and length of our sales cycle and our product mix;
- our ability to attract new customers and to transition customers of our installed learning management products to our Internet-based learning products;
- our history of losses and expectations of continued losses;
- our ability to manage growth;
- successful implementation of our operating and growth strategy;
- fluctuations in quarterly operating results caused by a variety of factors including the timing of sales and development contracts as well as the adoption of the Internet as a tool for online training and continuing education in the healthcare industry;
- our ability to successfully establish and maintain new and existing relationships with customers and content partners; and
- global and/or regional economic factors and potential changes in laws and regulations, including, without limitation, changes in federal, state and international laws regulating education, training and Internet transactions.

For additional information concerning risks and uncertainties that may affect our results of operations, please see the risks outlined under the heading "Risk Factors" in our Annual Report on Form 10-K filed with the Securities and Exchange Commission.

#### **Overview**

HealthStream was incorporated in 1990 and began marketing its Internet-based solutions in March 1999. We evolved from an initial focus of providing multimedia tools for information dissemination to facilitator of training tools for entities in the healthcare industry.

Revenues from the healthcare organization and professionals business unit ("HCO") are derived from the following categories: provision of services through our Internet-based learning products, licensing, maintenance and support of our installed learning management products, content subscriptions, custom content development, and a variety of online and enduring products. Revenues from the pharmaceutical and medical device business unit ("PMD") are derived from live event development, coordination, and registration services, Web cast events, online development and training, and other educational and training services.

For additional information concerning revenue recognition, please see the discussion outlined under the heading "Management's Discussion and Analysis of Financial Condition and Results of Operations – Overview and Critical Accounting Policies" and Notes to the Consolidated Financial Statements in our Annual Report on Form 10-K filed with the Securities and Exchange Commission. Except for applying the new accounting rules for goodwill and intangible assets, there have been no changes in our critical accounting policies or the application of such policies since December 31, 2001.

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In June 2001, the Financial Accounting Standards Board (“FASB”) No. 142, “Goodwill and Other Intangible Assets” (“Statement 142”). We adopted Statement 142 effective January 1, 2002. Statement 142 provides for the elimination of amortization of intangible assets that have indefinite lives, such as goodwill, as well as a modification of the approach and timing for evaluating impairment of intangible assets. As a result of the adoption of Statement 142, the transitional impairment loss recognized for the HCO reporting unit totaled approximately \$5.0 million, and was recorded as a cumulative effect of a change in accounting principle in our consolidated statement of operations as of January 1, 2002. See Notes 6 and 7 to the condensed consolidated financial statements for a discussion of the impact of this Statement on our consolidated financial position and results from operations.

During the quarter ended September 30, 2002, certain stock held in escrow related to our purchase of EMINet, Inc. was distributed or otherwise retired. In connection with the resolution, 85,625 shares of our common stock were retired. The retirement was recorded based on the market value of the shares on the date of retirement.

On January 5, 2001, we terminated our prior agreement with WebMD and entered into a new business arrangement. Under the new, non-exclusive three-year agreement, we are a preferred provider of continuing medical education, continuing education and board preparation courses for WebMD’s professional portal. Under this new arrangement, financial consideration is based entirely on revenues generated from the sale of our services to WebMD’s professional portal customers. The arrangement also terminated the lock-up agreement related to 1.1 million shares of our common stock that WebMD purchased in a private offering just prior to our IPO. In connection with this termination, we gave WebMD the right to sell the shares back to us at any time through March 30, 2001. On February 8, 2001, WebMD exercised its right to sell the 1.1 million shares of our common stock back to us at \$1.7833 per share. We reacquired the shares on February 16, 2001. In connection with the termination of the prior WebMD agreement, we recognized a gain of \$1.5 million representing the reversal of the scheduled \$1.5 million fixed payment, which was accrued during the quarter ended September 30, 2000.

Effective October 1, 2001, we entered into a new four-year agreement with HCA Information Technology & Services, Inc. (“HCA”), replacing the prior agreement with Columbia Information Systems, Inc. that had approximately two and one half years remaining. Together with HCA, we mutually agreed to cancel the warrant held by CIS Holdings, Inc., an affiliate of HCA, to purchase our common stock. As a result, we are no longer amortizing the remaining cost of the warrant as a reduction of revenues. Revenues through September 2001, provided under the prior service agreement that included the grant of the warrant to CIS Holdings, Inc., were recognized as services were rendered, net of the amortization of the fair value of the related warrant as a reduction of the revenues proportionately over the term of the four-year agreement. During the three and nine month periods ended September 30, 2001, we amortized \$549,077 and \$1,489,933, respectively, of warrant expense as a reduction of revenues. There was no corresponding reduction in the three or nine month periods ended September 30, 2002.

We expect to continue to generate revenues by marketing our Internet-based products and services to healthcare workers through healthcare organizations. We expect that the portion of our revenues related to services provided via our Internet-based learning products will increase. Specifically, we will seek to generate revenues from healthcare workers by marketing to their employers or sponsoring organizations. The transaction fees for courseware resulting from this marketing may either be paid by the employer or sponsoring organization or, in the case of healthcare professionals, may be billed directly to the individual. Our Internet-based learning model allows us to host our system in a central data center, therefore eliminating the need for costly onsite installations of our software. Under the Internet-based learning model, revenues are generated by charging for use of our learning management system and courseware on a subscription basis. In addition, we will continue to sell services on our Web site on a transaction basis.

To date, we have incurred substantial costs to develop our technologies, create, license and acquire our content, build brand awareness, develop our infrastructure and expand our business, and have yet to achieve significant revenues or generate positive operating cash flows. As a result, we have incurred operating losses in each fiscal quarter since 1994. We expect operating losses through at least the next twelve months, as we continue to expand our business. We believe that period-to-period comparisons of our financial results are not necessarily meaningful, and you should not rely upon them as an indication of our future performance.

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### **Results of Operations**

#### **Revenues and Expense Components**

The following descriptions of the components of revenues and expenses apply to the comparison of results of operations. As discussed in Note 1 to the Condensed Consolidated Financial Statements, we began producing discrete financial information under our HCO and PMD segments during 2001.

**Revenues.** Revenues currently consist of the provision of services through our Internet-based learning products, the licensing, maintenance and support of our installed learning management products, content subscriptions, online development, Web cast events, event development, coordination, and registration services, online products and commercial support, sale of online enduring products, and training services.

**Cost of Revenues.** Cost of revenues consist primarily of salaries and employee benefits, materials, hosting costs, and other direct expenses associated with revenues as well as royalties paid to content providers and distribution partners based on utilization.

**Product Development.** Product development expenses consist primarily of salaries and employee benefits, third-party content acquisition costs, costs associated with the development of new products, and costs associated with development of content and expenditures associated with developing, maintaining, and operating our Web sites, training delivery, and our Internet-based learning products.

**Sales and Marketing Expenses.** Sales and marketing expenses consist primarily of salaries, commissions and employee benefits, travel and lodging, advertising, promotions, and related marketing costs.

**Other General and Administrative Expenses.** Other general and administrative expenses consist primarily of salaries and employee benefits, facility costs, and fees for professional services.

**Depreciation and Amortization.** Depreciation and amortization consist of fixed asset depreciation, amortization of intangibles, amortization of content, license fees, and prepaid compensation and royalties paid to content providers that are of a fixed nature.

**Other Income/Expense.** The primary component of other expense is interest expense related to capital and other lease obligations. The primary component of other income is interest income related to interest earned on cash, cash equivalents and investments in marketable securities.

#### **Three Months Ended September 30, 2002 Compared to Three Months Ended September 30, 2001**

**Revenues.** Revenues increased approximately \$1.0 million, or 31.9%, from \$3.1 million for the three months ended September 30, 2001 to \$4.1 million for the three months ended September 30, 2002. Revenues for 2002 consisted of \$2.7 million for HCO and \$1.4 million for PMD. In 2001, revenues consisted of \$1.8 million for HCO and \$1.3 million for PMD. The increase in HCO revenues over 2001 related primarily to \$0.5 million resulting from the cancellation of a warrant to purchase our common stock previously held by HCA, which eliminated the amortization of the warrant value against revenues. During the three months ended September 30, 2002, the components of revenues for HCO changed as compared to the three months ended September 30, 2001 as revenues from our Internet-based learning products increased \$0.7 million and content subscription revenues increased \$0.1 million. These increases in revenues were offset by declines in HCO revenues of \$0.4 million for sales of licenses and maintenance fees associated with our installed learning management products, consistent with our strategy to transition these customers to our Internet-based learning products, and \$0.1 million from other content subscriptions. We expect revenues from our installed learning management products to continue to decline for the remainder of 2002 and into 2003 as we focus on our Internet-based learning products and continue to transition these customers to our Internet-based learning platform. Our Internet-based learning network represented approximately 50% of revenues for the three months ended September 30, 2002 as compared to 33% of revenues for the three months ended September 30, 2001. The increase in PMD revenues was driven by a \$0.3 million increase in live event services, offset by a \$0.2 million decline in online development and Web cast revenues. We expect Web cast revenues to continue to decline for the remainder of the year and into 2003, but do not expect this decline to have a material impact on PMD revenues.

**Cost of Revenues.** Cost of revenues increased approximately \$0.1 million, or 5.4%, from \$1.3 million for the three months ended September 30, 2001 to \$1.4 million for the three months ended September 30, 2002. Cost of revenues as a percentage of revenues decreased from 41.6% of revenues for the three months ended September 30, 2001 to 33.3% of revenues for the three months ended September 30, 2002, primarily as a result of the increased revenues and changes in revenue components discussed above. Cost of

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goods for HCO decreased approximately \$0.2 million, and approximated 14.2% and 31.3% of revenues for the three months ended September 30, 2002 and 2001, respectively. This percentage decreased in 2002 as a result of increased revenues and changes in revenue components, including the discontinuation of warrant expense, discussed above and reductions in personnel related expenses. Cost of goods for PMD increased approximately \$0.2 million, and approximated 64.0% and 54.8% of revenues for the three months ended September 30, 2002 and 2001, respectively. This percentage increased in 2002 due to increased material costs and personnel related expenses associated with our live event services and a redesignation of personnel related expenses associated with online development services as cost of goods, which were previously designated as product development costs in 2001.

*Product Development.* Product development expenses decreased approximately \$0.1 million, or 4.1%, from \$1.3 million for the three months ended September 30, 2001 to \$1.2 million for the three months ended September 30, 2002. While product development expenses were comparable between periods, we have increased our focus on the development of new products in 2002, and somewhat reduced our focus on the development, maintenance, and support of our installed learning management products and certain content. Product development expenses as a percentage of revenues decreased from 41.0% of revenues for the three months ended September 30, 2001 to 29.9% of revenues for the three months ended September 30, 2002. The decrease as a percentage of revenues is primarily due to the increase in revenues over the prior year. Product development expenses for HCO increased approximately \$0.1 million, and approximated 31.1% and 39.6% of revenues for the three months ended September 30, 2002 and 2001, respectively. Product development expenses for PMD decreased approximately \$0.1 million, and approximated 13.7% and 21.6% of revenues for the three months ended September 30, 2002 and 2001, respectively. The percentage decreased for PMD in 2002 due to a redesignation of personnel expenses and other direct costs associated with the development of content as a cost of revenues. Product development expenses for PMD in 2002 are primarily related to the development of new products.

*Sales and Marketing Expenses.* Sales and marketing expenses, including personnel costs, increased approximately \$0.1 million, or 4.0%, to \$1.5 million for the three months ended September 30, 2002 from \$1.4 million for the three months ended September 30, 2001. The increase is primarily a result of additional commissions associated with higher new contract values during the three months ended September 30, 2002 compared to the same period for 2001. This increase was partially offset by a reduction in personnel related expenses and travel expenses, while advertising and marketing expenses were comparable between periods. Sales and marketing expenses for HCO increased approximately \$0.1 million, and approximated 44.3% and 60.2% of revenues for the three months ended September 30, 2002 and 2001, respectively. The percentage decreased for HCO in 2002 due to increased HCO revenues, reduced personnel related expenses and travel, which were partially offset by increases in commissions. Sales and marketing expenses for PMD were comparable for the three months ended September 30, 2002 and 2001. As a percentage of revenues, sales and marketing approximated 20.8% and 25.7% for the three months ended September 30, 2002 and 2001, respectively. The percentage decreased for PMD related to a slight increase in revenues, as well as a decrease in personnel related expenses.

*Other General and Administrative Expenses.* Other general and administrative expenses decreased \$0.3 million, or 15.7%, from \$1.8 million for the three months ended September 30, 2001 to \$1.5 million for the three months ended September 30, 2002. The decrease primarily resulted from the consolidation of offices and corporate functions, including reductions in personnel related expenses and facilities costs. Other general and administrative expenses for HCO decreased approximately \$0.3 million, and approximated 8.8% and 28.6% of revenues for the three months ended September 30, 2002 and 2001, respectively. The percentage decreased for HCO in 2002 due to increased revenues and operating efficiencies achieved through the consolidation of offices. Other general and administrative expenses for PMD increased slightly in 2002, and were approximately 15.2% and 13.1% of revenues for the three months ended September 30, 2002 and 2001, respectively. Other general and administrative expenses for our unallocated corporate functions decreased \$0.1 million, or 3.7%, from \$1.1 million for the three months ended September 30, 2001 to \$1.0 million for the three months ended September 30, 2002.

*Depreciation and Amortization.* Depreciation and amortization decreased by approximately \$1.4 million, or 57.3%, from \$2.5 million for the three months ended September 30, 2001 to approximately \$1.1 million for the three months ended September 30, 2002. The decrease is attributable to the discontinuation of the amortization of goodwill, which resulted from the implementation of a new accounting standard, and a decrease in depreciation expense due to lower capital expenditures as compared to the prior year. As discussed in Note 6 to the Condensed Consolidated Financial Statements, pro forma net loss and pro forma net loss per share, adjusted for the discontinuation of goodwill amortization, resulted in a decrease of approximately \$1.3 million for the net loss or \$0.07 per share for the three months ended September 30, 2001.

*Other Income/Expense.* Other income and expense decreased \$0.2 million, from approximately \$0.4 million for the three months ended September 30, 2001 to approximately \$0.2 million for the three months ended September 30, 2002 primarily related to a reduction in interest income associated with our investments in marketable securities.

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**Net Loss.** Net loss decreased \$2.4 million, or 50.3%, from a loss of \$4.8 million for the three months ended September 30, 2001 to a loss of \$2.4 million for the three months ended September 30, 2002 due to the factors described above. Pro forma net loss, adjusted for the discontinuation of goodwill amortization, decreased approximately \$1.1 million, or 30.8%, from a loss of \$3.5 million for the three months ended September 30, 2001 to a loss of \$2.4 million for the three months ended September 30, 2002.

### **Nine Months Ended September 30, 2002 Compared to Nine Months Ended September 30, 2001**

**Revenues.** Revenues increased approximately \$2.1 million, or 21.5%, from \$9.6 million for the nine months ended September 30, 2001 to \$11.7 million for the nine months ended September 30, 2002. Revenues for 2002 consisted of \$7.1 million for HCO and \$4.6 million for PMD. In 2001, revenues consisted of \$5.5 million for HCO and \$4.1 million for PMD. The increase in HCO revenues over 2001 related primarily to \$1.5 million resulting from the cancellation of a warrant to purchase our common stock previously held by HCA, which eliminated the amortization of the warrant value against revenues. During the nine months ended September 30, 2002, the components of revenues for HCO changed compared to the nine months ended September 30, 2001 as revenues from our Internet-based learning products increased \$1.6 million, content subscription revenues increased \$0.2 million, and training services increased \$0.1 million. These increases were offset by declines in HCO revenues of \$1.5 million in sales of licenses and maintenance fees associated with our installed learning management products, consistent with our strategy to transition these customers to our Internet-based learning products and \$0.3 million in content development revenues. We expect revenues from our installed learning management products to continue to decline for the remainder of 2002 and into 2003 as we focus more on our Internet-based learning products and continue to transition these customers to our Internet-based learning platform. The increase in PMD revenues over 2001 related primarily to \$0.8 million for live event services, offset by declines of \$0.3 million in Web cast revenues. We expect Web cast revenues to continue to decline for the remainder of the year and into 2003, but do not expect this decline to have a material impact on PMD revenues.

**Cost of Revenues.** Cost of revenues increased approximately \$0.6 million, or 16.1%, from \$4.1 million for the nine months ended September 30, 2001 to \$4.7 million for the nine months ended September 30, 2002. The increase resulted primarily from additional costs associated with delivering products and services to our pharmaceutical and medical device customers, such as personnel expenses, travel, contract labor, and materials. Cost of revenues as a percentage of revenues decreased from 42.3% of revenues for the nine months ended September 30, 2001 to 40.4% of revenues for the nine months ended September 30, 2002. Cost of revenues for HCO decreased approximately \$0.4 million, and approximated 21.9% and 36.1% of revenues for the nine months ended September 30, 2002 and 2001, respectively. The decrease as a percentage of revenues for HCO is a result of both increased revenues and changes in revenue components, including the elimination of warrant expense, discussed above and decreases in personnel related expenses, travel and hosting fees. Cost of revenues for PMD increased approximately \$0.9 million, and approximated 63.5% and 48.3% of revenues for the nine months ended September 30, 2002 and 2001, respectively. This percentage increased in 2002 due to additional personnel expenses and other direct costs associated with our live event services and a redesignation of personnel expenses and other direct costs associated with online development services as a cost of revenues, which were previously designated as product development costs in 2001.

**Product Development.** Product development expenses decreased approximately \$0.3 million, or 8.3%, from \$3.7 million for the nine months ended September 30, 2001 to \$3.4 million for the nine months ended September 30, 2002. The reduction in product development expenses is associated with our reduced focus on the development, maintenance, and support of our installed learning management products and certain content. Product development expenses as a percentage of revenues decreased to 29.3% of revenues for the nine months ended September 30, 2002 compared to 38.8% of revenues for the nine months ended September 30, 2001. The decrease as a percentage of revenues resulted from increased revenues and lower support costs associated with our installed learning management products and lower development costs associated with content and application maintenance. Product development expenses for HCO increased approximately \$0.4 million, and approximated 33.0% and 35.2% of revenues for the nine months ended September 30, 2002 and 2001, respectively. The increase is related to the development of content and other new products. Product development expenses for PMD decreased approximately \$0.3 million, and approximated 10.7% and 18.4% for the nine months ended September 30, 2002 and 2001, respectively. The percentage decreased for PMD due to a redesignation of personnel expenses and other direct costs associated with the development of content as a cost of revenues. Product development expenses for PMD in 2002 are primarily associated with the development of new products. The unallocated portion of our product development expenses decreased approximately \$0.5 million in 2002, primarily resulting from an increased focus on the development of content and new products in HCO. Our product development efforts have shifted from platform development by corporate personnel in 2001 to specific new product developments within both HCO and PMD in 2002.

**Office Consolidation Charge.** During the nine months ended September 30, 2001, we recorded a non recurring office consolidation charge of \$0.4 million as a result of consolidating offices and corporate functions. The charge consisted of lease obligations of approximately \$0.2 million and impairment of certain fixed assets of approximately \$0.2 million.

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**Sales and Marketing Expenses.** Sales and marketing expenses, including personnel costs, increased approximately \$0.3 million, or 7.3%, to \$4.7 million for the nine months ended September 30, 2002 from \$4.4 million for the nine months ended September 30, 2001. The increase is a result of additional commissions associated with higher new contract values for the nine months ended September 30, 2002 when compared to the same period in 2001. This increase was partially offset by decreases in personnel related expenses and travel. Sales and marketing expenses as a percentage of revenues decreased from 45.4% for the nine months ended September 30, 2001 to 40.1% for the nine months ended September 30, 2002, as a result of increased revenues discussed above. Sales and marketing expenses for HCO were comparable between years, and approximated 48.7% and 62.5% of revenues for the nine months ended September 30, 2002 and 2001, respectively. The percentage decreased for HCO during 2002 due to the increased revenues discussed above and decreases in travel expenses, which were somewhat offset by increased commissions. Sales and marketing expenses for PMD increased approximately \$0.2 million, and approximated 25.4% and 22.5% of revenues for the nine months ended September 30, 2002 and 2001, respectively. The percentage increased for PMD during 2002 due to additional commissions associated with higher new contract value during the nine months ended September 30, 2002 compared to the same period for 2001.

**Other General and Administrative Expenses.** Other general and administrative expenses decreased approximately \$0.3 million, or 4.6%, from \$5.4 million for the nine months ended September 30, 2001 to \$5.1 million for the nine months ended September 30, 2002. Excluding the one-time gain of \$1.5 million on the renegotiation of the WebMD agreement during the nine months ended September 30, 2001, other general and administrative expenses decreased approximately \$1.8 million, or 32.6%, as a result from the consolidation of offices and corporate functions. Other general and administrative expenses as a percentage of revenues approximated 43.6% and 55.5% of revenues for the nine months ended September 30, 2002 and 2001, respectively. Other general and administrative expenses for HCO decreased \$0.8 million and approximated 16.0% and 35.9% of revenues for the nine months ended September 30, 2002 and 2001, respectively. The percentage decreased as a result of increased revenues and lower expenses associated with the consolidation of offices. Other general and administrative expenses for PMD increased approximately \$0.1 million, and approximated 15.4% and 15.2% of revenues for the nine months ended September 30, 2002 and 2001, respectively. Other general and administrative expenses for our unallocated corporate functions, excluding the one-time gain of \$1.5 million on the renegotiation of the WebMD agreement, decreased \$1.0 million, or 23.2%, from \$4.3 million for the nine months ended September 30, 2001 to \$3.3 million for the nine months ended September 30, 2002. The decrease is primarily a result of the consolidation of offices and corporate functions.

**Depreciation and Amortization.** Depreciation and amortization decreased by approximately \$4.0 million, or 54.5%, from \$7.4 million for the nine months ended September 30, 2001 to approximately \$3.4 million for the nine months ended September 30, 2002. The decrease is attributable to the discontinuation of the amortization of goodwill, which resulted from the implementation of new accounting standards. As discussed in Note 6 to the Condensed Consolidated Financial Statements, pro forma net loss and pro forma net loss per share, adjusted for the discontinuation of goodwill amortization, resulted in a decrease of approximately \$4.0 million for the net loss or \$0.20 per share for the nine months ended September 30, 2001.

**Other Income/Expense.** Other income and expense decreased \$0.8 million, from approximately \$1.4 million for the nine months ended September 30, 2001 to approximately \$0.6 million for the nine months ended September 30, 2002 due to a reduction in interest income associated with our investments in marketable securities. This reduction in income is associated with lower investment balances and, to a lesser degree, lower yield rates.

**Cumulative effect of a change in accounting principle.** We adopted SFAS No.142 "Goodwill and Intangible Assets," effective January 1, 2002. Under the transitional provisions of SFAS 142, we recorded a non-cash goodwill impairment charge associated with the HCO business unit of \$5.0 million. The non-cash charge has been recorded as a cumulative effect of a change in accounting principle as of January 1, 2002. See Note 6 to the Condensed Consolidated Financial Statements for additional information.

**Net Loss.** Net loss decreased approximately \$0.3 million, or 2.3%, from a loss of \$14.4 million for the nine months ended September 30, 2001 to a loss of \$14.1 million for the nine months ended September 30, 2002, due to the factors described above. Pro forma net loss, adjusted for discontinuation of goodwill amortization of \$4.0 million and adjusted for the cumulative effect of a change in accounting principle of \$5.0 million, decreased \$1.3 million, or 12.6%, from a loss of \$10.4 million for the nine months ended September 30, 2001 to a loss of \$9.1 million for the nine months ended September 30, 2002.

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### **Liquidity and Capital Resources**

Since our inception, we have financed our operations largely through proceeds from our initial public offering, private placements of equity securities, loans from related parties and, to a lesser extent, from revenues generated from the sale of our products and services.

Net cash used in operating activities was \$5.0 million during the nine months ended September 30, 2002 and \$8.9 million during the nine months ended September 30, 2001. Cash used in operating activities during the nine months ended September 30, 2002 resulted from the net loss before the cumulative effect of a change in accounting principle of \$9.1 million, an increase in accounts and unbilled receivables and a decrease in accounts payable. These operating uses of cash were offset by decreases in interest receivable and other assets, increases in restricted cash, accrued liabilities and deferred revenue, as well as depreciation and amortization. Cash used in operating activities during the nine months ended September 30, 2001 related to the \$14.4 million net loss, the non cash gain on the WebMD renegotiation, increases in accounts and unbilled receivables, prepaid development, prepaid expenses and other current assets and decreases in accounts payable, accrued liabilities, and registration liabilities. These operating uses of cash were offset by non cash warrant expense, the office consolidation charge, depreciation and amortization, as well as a decline in restricted cash and other assets.

Net cash provided by investing activities was \$5.3 million during the nine months ended September 30, 2002 while \$2.2 million of cash was used in investing activities during the nine months ended September 30, 2001. Cash provided by investing activities during the nine months ended September 30, 2002 related to the excess of proceeds from the sale and maturities over purchases of investments in marketable securities of \$5.9 million, offset by \$0.5 million for the purchase of property and equipment. During the nine months ended September 30, 2001, cash used in investing activities related to \$0.8 million associated with the excess of purchases over sales and maturities of investments in marketable securities, \$0.3 million for the purchase of de'MEDICI Systems, \$0.2 million from the issuance of a note receivable, and \$1.0 million for the purchase of property and equipment, which was offset by the receipt of \$0.1 million for the repayment of a note.

Cash used in financing activities was \$0.1 million for the nine months ended September 30, 2002 and \$2.2 million for the nine months ended September 30, 2001. Cash used in financing activities during the nine months ended September 30, 2002 related to payments under capital lease obligations offset by proceeds from the issuance of common stock to our Employee Stock Purchase Plan. Cash used in financing activities during the nine months ended September 30, 2001 related to \$2.0 million for the repurchase of common stock from WebMD and \$0.3 million related to payments under capital lease obligations, offset by proceeds from the issuance of common stock to our Employee Stock Purchase Plan.

As of September 30, 2002 our primary source of liquidity was \$21.1 million of cash and cash equivalents, restricted cash, investments in marketable securities, and interest receivable. We have no bank credit facility or other indebtedness other than capital lease obligations. As of October 31, 2002 we had cash and cash equivalents, restricted cash, investments in marketable securities, and interest receivable of approximately \$21.0 million.

We believe that our existing cash and cash equivalents, restricted cash, investments in marketable securities, and interest receivable will be sufficient to meet anticipated cash needs for working capital, new product development, capital expenditures and acquisitions for at least the next 12 months. Our growth strategy may also include acquiring companies that complement our products and services. We anticipate that these acquisitions, if any, will be effected through a combination of issuance of our common stock and cash consideration. Failure to generate sufficient cash flow from operations or raise additional capital when required in sufficient amounts and on acceptable terms could harm our business, financial condition and results from operations.

### **Commitments and Contingencies**

In connection with our October 2001 agreement with HCA, HCA will pay us minimum revenues of \$12.0 million over the four-year term of the agreement.

We also expect to incur additional product development costs, some of which will be capitalized, as we continue investing in the development of new products. We expect that our capital expenditures will be approximately \$0.2 to \$0.3 million for the remainder of 2002.

Our strategic alliances have typically provided for payments to distribution, content and development partners based on revenues, and we expect to continue similar arrangements in the future. In addition, our lease obligations for the remainder of 2002 through the end of 2006 total approximately \$1.5 million.

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### **Item 3. Quantitative and Qualitative Disclosure about Market Risk**

We are exposed to market risk from changes in interest rates, and to a lesser degree, we are exposed to foreign currency exchange rate risk on certain transactions with our customers in Canada. We do not have any commodity price risk. As of September 30, 2002, we had no outstanding indebtedness other than approximately \$133,000 of capital lease arrangements. Accordingly, we are not exposed to significant market risk. We are exposed to market risk with respect to the cash and cash equivalents and marketable securities that we invest. At October 31, 2002, we had approximately \$21.0 million of cash and cash equivalents, restricted cash, investments in marketable securities, and accrued interest that were invested in a combination of short and long-term investments. At this investment level, a hypothetical 10% decrease in the interest rate would decrease interest income and increase net loss on an annualized basis by approximately \$210,000. At September 30, 2002, the average maturity for our investment portfolio approximated twelve months.

We manage our investment risk by investing in corporate debt securities, foreign corporate debt and secured corporate debt securities with minimum acceptable credit ratings. For certificates of deposit and corporate obligations, ratings must be A2/A or better; A1/P1 or better for commercial paper; A2/A or better for taxable or tax advantaged auction rate securities and AAA or better for tax free auction rate securities. We also require 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, our 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**

HealthStream's chief executive officer and chief financial officer have reviewed and evaluated the effectiveness of HealthStream's disclosure controls and procedures (as defined in Exchange Act Rules 13a-14(c) and 15d-14(c)) as of a date within ninety days before the filing date of this quarterly report. Based on that evaluation, the chief executive officer and chief financial officer have concluded that HealthStream's disclosure controls and procedures effectively and timely provide them with material information relating to HealthStream and its consolidated subsidiaries required to be disclosed in the reports HealthStream files or submits under the Exchange Act. There have not been any significant changes in HealthStream's internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation. There were no significant deficiencies or material weaknesses, and therefore no corrective actions were taken.

## **PART II — OTHER INFORMATION**

### **Item 6. Exhibits and Reports on Form 8-K.**

#### **(a) Exhibits**

- |      |   |  |
|------|---|--|
| 99.1 | - | Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| -    |   |  |
| 99.2 | - | Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| -    |   |  |

#### **(b) Reports on Form 8-K**

None

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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.

By: /s/ Arthur E. Newman

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Arthur E. Newman  
Chief Financial Officer  
November 12, 2002

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**CERTIFICATION**

I, Robert A. Frist, certify that:

1. I have reviewed this quarterly report on Form 10-Q of HealthStream, Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
  - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
  - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
  - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

/s/ ROBERT A. FRIST

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Robert A. Frist  
Chief Executive Officer  
November 12, 2002

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**CERTIFICATION**

I, Arthur E. Newman, certify that:

1. I have reviewed this quarterly report on Form 10-Q of HealthStream, Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
  - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
  - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
  - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

/s/ ARTHUR E. NEWMAN

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Arthur E. Newman  
Chief Financial Officer  
November 12, 2002

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**HEALTHSTREAM, INC.**

**EXHIBIT INDEX**

- |      |  |
|------|--|
| 99.1 | Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 99.2 | Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of HealthStream, Inc. (the "Company") on Form 10-Q for the period ending September 30, 2002, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), Robert A. Frist, Chief Executive Officer of the Company certifies, pursuant to 18 U.S.C. ss. 1350, as adopted pursuant to ss. 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ ROBERT A. FRIST

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Robert A. Frist  
Chief Executive Officer  
November 12, 2002

CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of HealthStream, Inc. (the "Company") on Form 10-Q for the period ending September 30, 2002, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), Arthur E. Newman, Chief Financial Officer of the Company certifies, pursuant to 18 U.S.C. ss. 1350, as adopted pursuant to ss. 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ ARTHUR E. NEWMAN

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Arthur E. Newman  
Chief Financial Officer  
November 12, 2002