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, 2006

Commission File No.: 000-27701

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

Tennessee	**62-1443555**
(State or other jurisdiction of incorporation or organization)	(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 o

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

Large accelerated filer o Accelerated filer o Non-accelerated filer ☑

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

As of August 10, 2006, 21,927,687 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

	June 30, 2006 (Unaudited)	December 31, 2005 (Note 1)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 7,257,639	$ 5,726,151
Investments in short term marketable securities	5,996,493	6,175,000
Restricted cash	96,365	238,538
Interest receivable	58,873	54,524
Accounts receivable, net of allowance for doubtful accounts of $102,672 at June 30, 2006 and $115,090 at December 31, 2005	4,301,136	4,691,402
Accounts receivable — unbilled	680,462	706,011
Prepaid development fees and content rights, net of amortization	1,246,876	684,351
Other prepaid expenses and other current assets	1,766,029	950,687
Total current assets	21,403,873	19,226,664
Property and equipment:		
Equipment	7,924,320	7,446,451
Leasehold improvements	1,453,377	1,281,460
Furniture and fixtures	1,052,574	1,011,877
	10,430,271	9,739,788
Less accumulated depreciation and amortization	(8,269,530)	(7,636,306)
	2,160,741	2,103,482
Goodwill	10,317,393	10,317,393
Intangible assets, net of accumulated amortization of $7,501,994 at June 30, 2006 and $7,247,828 at December 31, 2005	3,010,148	3,264,314
Other assets	683,053	304,287
Total assets	$ 37,575,208	$ 35,216,140
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 849,397	$ 933,895
Accrued liabilities	1,959,651	1,487,568
Accrued compensation and related expenses	404,981	639,468
Registration liabilities	83,204	231,142
Commercial support liabilities	584,705	1,239,124
Deferred revenue	5,011,336	4,502,924
Current portion of capital lease obligations	185,049	166,022
Total current liabilities	9,078,323	9,200,143
Capital lease obligations, less current portion	195,729	215,856
Other long-term liabilities	525,000	—
Commitments and contingencies	—	—
Shareholders' equity:		
Common stock, no par value, 75,000,000 shares authorized; 21,927,687 and 21,574,904 shares issued and outstanding at June 30, 2006 and December 31, 2005, respectively	94,828,801	93,799,932
Accumulated deficit	(67,052,645)	(67,999,791)
Total shareholders' equity	27,776,156	25,800,141
Total liabilities and shareholders' equity	$ 37,575,208	$ 35,216,140

See accompanying notes to the condensed consolidated financial statements.

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

	Three Months Ended June 30, 2006	Three Months Ended June 30, 2005
Revenues, net	$ 8,223,700	$ 6,806,420
Operating costs and expenses:		
Cost of revenues (excluding depreciation and amortization)	3,161,708	2,459,438
Product development	836,819	743,101
Sales and marketing	2,033,016	1,601,201
Depreciation	328,589	401,950
Amortization of intangibles, content fees and feature enhancements	338,823	358,358
Other general and administrative expenses	1,396,549	1,272,012
Total operating costs and expenses	8,095,504	6,836,060
Income (loss) from operations	128,196	(29,640)
Other income (expense):		
Interest and other income	161,841	72,490
Interest and other expense	(9,358)	(4,653)
Total other income	152,483	67,837
Income before income taxes	280,679	38,197
Income tax (benefit) provision	(8,000)	15,000
Net income	$ 288,679	$ 23,197
Net income per share:		
Basic	$ 0.01	$ 0.00
Diluted	$ 0.01	$ 0.00
Weighted average shares of common stock outstanding:		
Basic	21,475,021	21,054,335
Diluted	22,469,102	22,064,179

See accompanying notes to the condensed consolidated financial statements.

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

	Six Months Ended June 30, 2006	Six Months Ended June 30, 2005
Revenues, net	$15,746,340	$12,488,822
Operating costs and expenses:		
Cost of revenues (excluding depreciation and amortization)	5,736,659	4,495,121
Product development	1,726,368	1,379,619
Sales and marketing	3,661,834	2,791,463
Depreciation	664,644	810,111
Amortization of intangibles, content fees and feature enhancements	646,338	568,178
Other general and administrative expenses	2,633,551	2,428,023
Total operating costs and expenses	15,069,394	12,472,515
Income from operations	676,946	16,307
Other income (expense):		
Interest and other income	304,688	177,940
Interest and other expense	(17,988)	(11,884)
Total other income	286,700	166,056
Income before income taxes	963,646	182,363
Income tax provision	16,500	15,000
Net income	$ 947,146	$ 167,363
Net income per share:		
Basic	$ 0.04	$ 0.01
Diluted	$ 0.04	$ 0.01
Weighted average shares of common stock outstanding:		
Basic	21,379,673	20,870,061
Diluted	22,304,104	21,765,611

See accompanying notes to the condensed consolidated financial statements.

HEALTHSTREAM, INC.
CONDENSED CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY (UNAUDITED)
SIX MONTHS ENDED JUNE 30, 2006

	Common Stock		Accumulated	Total Shareholders'
	Shares	Amount	Deficit	Equity
Balance at December 31, 2005	21,574,904	$93,799,932	$(67,999,791)	$ 25,800,141
Net income	—	—	947,146	947,146
Stock-based compensation	—	377,634	—	377,634
Issuance of common stock to Employee Stock Purchase Plan	68,102	162,083	—	162,083
Exercise of stock options	284,681	489,152	—	489,152
Balance at June 30, 2006	21,927,687	$94,828,801	$(67,052,645)	$ 27,776,156

See accompanying notes to the condensed consolidated financial statements.

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

	Six Months Ended June 30, 2006	Six Months Ended June 30, 2005
OPERATING ACTIVITIES:		
Net income	$ 947,146	$ 167,363
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	664,644	810,111
Amortization of intangibles, content fees, and feature enhancements	646,338	568,178
Stock-based compensation	377,634	—
Provision for doubtful accounts	—	15,000
Realized loss on disposal of property & equipment	593	4,854
Changes in operating assets and liabilities:		
Accounts and unbilled receivables	415,815	206,057
Restricted cash	142,173	81,751
Interest receivable	(4,349)	3,980
Prepaid development fees and content rights	(408,030)	(174,253)
Other prepaid expenses and other current assets	(982,842)	(276,820)
Other assets	143,557	(37,931)
Accounts payable	(84,498)	(209,814)
Accrued liabilities and compensation	(36,571)	(351,040)
Registration liabilities	(147,938)	(77,778)
Commercial support liabilities	(654,419)	622,542
Deferred revenue	403,412	(111,262)
Net cash provided by operating activities	1,422,665	1,240,938
INVESTING ACTIVITIES:		
Acquisition, net of cash acquired	—	(9,362,342)
Proceeds from maturities and sales of investments in marketable securities	9,725,000	10,525,000
Purchase of investments in marketable securities	(9,543,816)	(1,000,000)
Purchase of property and equipment	(634,429)	(521,039)
Net cash used in investing activities	(453,245)	(358,381)
FINANCING ACTIVITIES:		
Issuance of common stock to Employee Stock Purchase Plan	162,083	159,445
Exercise of stock options	489,152	478,515
Payments on capital lease obligations	(89,167)	(28,585)
Net cash provided by financing activities	562,068	609,375
Net increase in cash and cash equivalents	1,531,488	1,491,932
Cash and cash equivalents at beginning of period	5,726,151	2,257,372
Cash and cash equivalents at end of period	$ 7,257,639	$ 3,749,304
SUPPLEMENTAL CASH FLOW INFORMATION:		
Capital lease obligations incurred	$ 88,067	$ 313,031
Interest paid	$ 17,755	$ 8,168
Income taxes paid	$ 21,000	$ 15,000
Issuance of common stock in connection with acquisition of company	$ —	$ 1,343,149
Effects of acquisition:		
Estimated fair value of tangible assets acquired	$ —	$ 718,357
Estimated fair value of liabilities assumed	—	(655,907)
Purchase price in excess of net tangible assets acquired	—	10,660,852
Less fair value of stock issued	—	(1,343,149)
Cash paid	—	9,380,153
Less cash acquired	—	(17,811)
Net cash paid for acquisition	$ —	$ 9,362,342

See accompanying notes to the condensed consolidated financial statements.

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, condensed consolidated financial statements 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 six months ended June 30, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006.

The balance sheet at December 31, 2005 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 a complete set of financial statements. For further information, refer to the consolidated financial statements and footnotes thereto for the year ended December 31, 2005 (included in the Company's Annual Report on Form 10-K, filed with the Securities and Exchange Commission).

2. STOCK-BASED COMPENSATION

In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123(R), "Share-Based Payments." Statement 123(R) supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees," (APB 25) and requires companies to recognize compensation expense, using a fair-value based method, for costs related to share-based payments, including stock options. The Company adopted Statement 123(R) on January 1, 2006 and implemented it using the modified-prospective method for transition purposes, therefore prior period financial results have not been restated. The modified-prospective method requires compensation expense be recorded for all unvested share-based payments outstanding prior to adoption and for all share-based payments issued subsequent to adoption using a fair value approach. We use the Black Scholes option pricing model for calculating the fair value of awards issued under our stock-based compensation plans.

Total stock-based compensation expense recorded, as a result of adopting Statement 123(R), for the three and six months ended June 30, 2006, which is recorded in our statements of operations, is as follows:

	Three months ended June 30, 2006	Six months ended June 30, 2006
Cost of revenues (excluding depreciation and amortization)	$ 10,345	$ 29,759
Product development	31,113	71,665
Sales and marketing	25,071	65,361
Other general and administrative	161,729	210,849
Total stock-based compensation expense	$ 228,258	$ 377,634

Prior to adopting Statement 123(R), we accounted for our stock-based compensation plans under the intrinsic value-based method of accounting prescribed by APB 25 and related interpretations. The following pro forma table reflects our net income (loss) and net income (loss) per share had the fair value provisions of SFAS No. 123 "Accounting for Stock-Based Compensation" been followed during the three and six months ended June 30, 2005:

	Three Months Ended June 30, 2005	Six Months Ended June 30, 2005
Net income as reported	$ 23,197	$ 167,363
Add: Stock-based employee compensation expense included in reported net income, net of related taxes	—	—
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards net of related tax effects	(198,540)	(284,240)
Pro forma net loss	$ (175,343)	$ (116,877)
Basic net income per share — as reported	$ 0.00	$ 0.01
Basic net loss per share — pro forma	$ (0.01)	$ (0.01)
Diluted net income per share — as reported	$ 0.00	$ 0.01
Diluted net loss per share — pro forma	$ (0.01)	$ (0.01)

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

2. STOCK-BASED COMPENSATION (continued)

Stock Option Plans

Our 2000 Stock Incentive Plan (2000 Plan) and 1994 Employee Stock Option Plan (1994 Plan) (the 2000 Plan and the 1994 Plan are collectively referred to as “the Plan”) authorize the grant of options or other forms of stock-based compensation to employees, officers, directors, and others and such grants must be approved by the Compensation Committee of the Board of Directors. The terms of both plans are substantially similar. Options granted under the Plan have terms of no more than ten years with certain restrictions. The Plan allows the Compensation Committee of the Board of Directors to determine the vesting period of each grant. The vesting period of the options granted ranges from immediate vesting (generally associated with professional consulting boards and directors’ options) to annual vesting over four years, beginning one year after the grant date (generally for employee and officer options). As of June 30, 2006, 2,117,293 shares of unissued common stock remain reserved for future grants under the Plan. The Company issues new shares of common stock when options are exercised.

The fair value of stock-based awards granted during the six months ended June 30, 2006 was estimated using the Black Scholes option pricing model, with the assumptions as follows:

Risk-free interest rate	4.55 -- 5.07%
Expected dividend yield	0.0%
Expected life (in years)	5 to 8
Expected forfeiture rate	0-15%
Volatility	75%

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

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

Expected life is the period of time the option is expected to remain outstanding, and is based on historical experience. The contractual option life ranges from eight to ten years.

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

Volatility is the measure of the amount by which the price is expected to fluctuate. We estimate volatility based on the actual historical volatility of our common stock, which we believe future volatility will be similar to our past experience.

We amortize the fair value of all stock-based awards on a straight-line basis over the requisite service period, which generally is the vesting period.

A summary of stock option activity and various other information relative to stock options for the six months ended June 30, 2006 is presented in the table below.

	Common Shares	Weighted-Average Exercise Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value
Outstanding at December 31, 2005	2,794,415	$ 3.41		
Granted	432,500	3.02		
Exercised	(284,681)	1.72		
Expired	(50,100)	4.74		
Forfeited	(69,000)	2.36		
Outstanding at June 30, 2006	2,823,134	$ 3.52	4.5 years	$ 2,986,807
Exercisable at June 30, 2006	1,904,384	$ 3.86	4.9 years	$ 2,061,085

2. STOCK-BASED COMPENSATION (continued)

The aggregate intrinsic value in the table above represents the total difference between the Company's closing stock price on June 30, 2006 of $3.82 and the option exercise price, multiplied by the number of in-the-money options as of June 30, 2006. As of June 30, 2006, total unrecognized compensation expense related to non-vested stock options is $1,270,740, net of estimated forfeitures, with a weighted average expense recognition period of 3 years.

Other information relative to option activity during the three and six month periods ended June 30, 2006 and 2005 is as follows:

	Three Months Ended		Six Months Ended	
	June 30, 2006	June 30, 2005	June 30, 2006	June 30, 2005
Weighted average grant date fair value of stock options granted	$ 2.28	$ 1.97	$ 1.99	$ 2.01
Total fair value of stock options vested	$ 186,050	$ 133,670	$ 533,146	$ 328,932
Total intrinsic value of stock options exercised	$ 656,582	$ 179,148	$ 661,127	$ 242,298
Cash proceeds from exercise of stock options	$ 456,810	$ 423,456	$ 489,152	$ 478,515

Employee Stock Purchase Plan
Our Employee Stock Purchase Plan (Purchase Plan) incorporates the provisions of Section 423 of the Internal Revenue Code. Under the Purchase Plan, 1,000,000 shares of common stock have been reserved for purchase by employees. The Purchase Plan provides for annual offer periods of twelve months to eligible employees. Under the Purchase Plan, eligible employees can purchase through payroll deductions, the lower of up to 15% of their eligible base compensation or 2,500 shares of common stock, at a price equivalent to 85% of the lower of the beginning or end of year price. As of June 30, 2006, there are 623,774 shares available for issuance under the Purchase Plan. In accordance with the provisions of Statement 123(R), the Company recognized $4,305 and $41,300 of stock-based compensation expense for the Purchase Plan during the three and six months ended June 30, 2006, respectively.

3. BUSINESS COMBINATION

On March 28, 2005, the Company acquired all of the stock of Data Management & Research, Inc. (DMR) for approximately $10.7 million, consisting of $9.1 million in cash and 479,234 shares of our common stock. Of the common stock portion, 319,489 shares were deposited in an escrow account to be held for eighteen months from the acquisition date, subject to any claims for indemnification pursuant to the stock purchase agreement. There have been no claims against the escrowed shares as of June 30, 2006. The Company also incurred direct, incremental expenses associated with the acquisition of approximately $0.4 million. Goodwill recorded in connection with the acquisition will generate deductible amortization for federal income tax purposes. DMR provides healthcare organizations a wide range of quality and satisfaction surveys, data analyses of survey results, and other research-based measurement tools focused on physicians, patients, and employees. The results of operations for DMR have been included in the Company's statement of operations effective March 29, 2005.

The following unaudited results of operations give effect to the operations of DMR as if the acquisition had occurred as of January 1, 2005. These unaudited results of operations include certain adjustments arising from the acquisition such as owner compensation and amortization expense. The pro forma results of operations do not purport to represent what the Company's results of operations would have been had such transactions in fact occurred at the beginning of the period presented or to project the Company's results of operations in any future period.

	Six months ended June 30, 2005
Revenue	$ 13,899,025
Net income	$ 640,724
Net income per share:	
Basic and diluted	$ 0.03

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

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 1.8 million and 1.4 million for the three and six months ended June 30, 2006 and 2005, respectively.

The following table sets forth the computation of basic and diluted net income per share for three and six months ended June 30, 2006 and 2005:

	Three Months Ended		Six Months Ended	
	June 30, 2006	June 30, 2005	June 30, 2006	June 30, 2005
Numerator:				
Net income	$ 288,679	$ 23,197	$ 947,146	$ 167,363
Denominator:				
Weighted average shares outstanding:				
Basic	21,475,021	21,054,335	21,379,673	20,870,061
Employee stock options and other	994,081	1,009,844	924,431	895,550
Diluted	22,469,102	22,064,179	22,304,104	21,765,611
Net income per share:				
Basic	$ 0.01	$ 0.00	$ 0.04	$ 0.01
Diluted	$ 0.01	$ 0.00	$ 0.04	$ 0.01

5. BUSINESS SEGMENTS

We have two reportable segments, services provided to healthcare organizations and professionals (HCO) and services provided to pharmaceutical and medical device companies (PMD). On March 28, 2005, we acquired DMR, a company focused on offering healthcare organizations a wide range of quality and satisfaction surveys, data analyses of survey results, and other research-based measurement tools. Accordingly, DMR has been included in our HCO business segment. 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, 2005. We manage and operate our business segments based on the markets they serve and the products and services provided to those markets.

The following is our business segment information as of and for the three and six months ended June 30, 2006 and 2005. We measure segment performance based on operating income (loss) before income taxes and prior to the allocation of corporate overhead expenses, interest income, interest expense, and depreciation.

	Three months ended	
	June 30, 2006	June 30, 2005
Revenues		
HCO	$ 6,383,857	$ 5,272,959
PMD	1,839,843	1,533,461
Total net revenue	$ 8,223,700	$ 6,806,420
Income (loss) from operations		
HCO	$ 2,351,384	$ 1,764,879
PMD	(284,746)	89,148
Unallocated	(1,938,442)	(1,883,667)
Total income (loss) from operations	$ 128,196	$ (29,640)

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

5. BUSINESS SEGMENTS (continued)

	Six months ended June 30, 2006	Six months ended June 30, 2005
Revenues		
HCO	$12,117,026	$ 9,239,954
PMD	3,629,314	3,248,868
Total net revenue	$15,746,340	$12,488,822
Income (loss) from operations		
HCO	$ 4,483,772	$ 3,350,097
PMD	(79,578)	318,708
Unallocated	(3,727,248)	(3,652,498)
Total income from operations	$ 676,946	$ 16,307

6. GOODWILL

We account for goodwill under the provisions of SFAS No. 142, “Goodwill and Other Intangible Assets.” We test goodwill for impairment using a discounted cash flow model. 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 impairment charges, which could adversely impact our operating results for the period in which such a determination is made. We perform our annual impairment evaluation of goodwill during the fourth quarter of each year and as changes in facts and circumstances indicate impairment exists.

On March 28, 2005, we acquired DMR. The amount of goodwill related to the acquisition of DMR at June 30, 2005 represented a preliminary estimate, and was subsequently adjusted based on the final purchase price allocation, which was completed during the fourth quarter of 2005. There were no changes in the carrying amount of goodwill during the six months ended June 30, 2006.

	HCO	PMD	Total
Balance at January 1, 2006	$8,993,666	$1,323,727	$10,317,393
Changes in carrying value of goodwill	—	—	—
Balance at June 30, 2006	$8,993,666	$1,323,727	$10,317,393

	HCO	PMD	Total
Balance at January 1, 2005	$1,982,961	$1,323,727	$ 3,306,688
Changes in carrying value of goodwill	8,010,852	—	8,010,852
Balance at June 30, 2005	$9,993,813	$1,323,727	$11,317,540

7. INTANGIBLE ASSETS

All identifiable intangible assets have been evaluated in accordance with SFAS No. 142 and are considered to have finite useful lives. Intangible assets with finite lives are being amortized over their estimated useful lives, ranging from one to eight years. Amortization of intangible assets was $127,083 and $254,166 for the three and six months ended June 30, 2006, respectively, and $224,072 and $311,972 for the three and six months ended June 30, 2005, respectively.

Identifiable intangible assets are comprised of the following:

	As of June 30, 2006			As of December 31, 2005		
	Gross Amount	Accumulated Amortization	Net	Gross Amount	Accumulated Amortization	Net
Customer related	$ 6,340,000	$(3,474,743)	$2,865,257	$ 6,340,000	$(3,262,243)	$3,077,757
Content	3,500,000	(3,500,000)	—	3,500,000	(3,500,000)	—
Other	672,142	(527,251)	144,891	672,142	(485,585)	186,557
Total	$10,512,142	$(7,501,994)	$3,010,148	$10,512,142	$(7,247,828)	$3,264,314

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

7. INTANGIBLE ASSETS (continued)

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

July 1, 2006 through December 31, 2006	$ 254,167
2007	508,333
2008	444,891
2009	425,000
2010 and thereafter	1,377,757
Total	$ 3,010,148

8. CONTENT RIGHTS AND DEFERRED SERVICE CREDITS

During the three months ended June 30, 2006, we completed updates and maintenance required to publish certain courseware owned by one of our customers and were provided the right to distribute and resell such courseware to our Internet-based customers. In exchange for receipt of an exclusive license to distribute and resell this courseware, we provided the customer with service credits that can be used to make future purchases of our products and services. We accounted for this transaction in accordance with Accounting Principles Board Opinion No. 29 “Accounting for Nonmonetary Transactions.” The value assigned to the content rights and the deferred service credits was $904,167, which represents the estimated fair value of the assets relinquished. The content rights are classified within prepaid development fees and other assets, and the service credits are classified within accrued liabilities and other long-term liabilities on our condensed consolidated balance sheet as of June 30, 2006.

The service credits will be issued annually through December 31, 2008 and they expire twenty-four months after issuance, and unused credits will be forfeited. As of June 30, 2006, we are obligated to issue remaining credits of $799,167 through December 31, 2008. Additional service credits may be provided in the future if the customer provides additional courseware rights to us. The content rights are being amortized on a straight-line basis through December 31, 2008. Revenues for services provided in exchange for service credits will be recognized in accordance with our revenue recognition policies.

9. INCOME TAXES

Taxable income for the year is expected to be reduced by available net operating loss carryforwards to the extent allowed by current tax regulations. We expect to achieve taxable income for the full year of 2006, and have recorded a tax provision of $16,500 associated with the alternative minimum tax based on taxable income for the six months ended June 30, 2006. The $8,000 tax benefit recorded during the three months ended June 30, 2006 resulted primarily from stock option exercises.

10. SUBSEQUENT EVENT

On July 21, 2006, the Company entered into a revolving credit facility loan agreement with SunTrust Bank for an aggregate principal amount of $7.0 million. The loan matures on July 21, 2009, and bears interest at a variable rate based on the 30 Day LIBOR Rate plus 150 basis points. The revolving credit facility includes certain financial and other covenants, including a maximum leverage ratio and minimum net tangible worth requirement. Borrowings under the revolving credit facility may be used to provide funds for general working capital needs, permitted acquisitions (as defined in the loan agreement), and for stock repurchase and/or redemption transactions that SunTrust Bank may authorize. Unused balances under the revolving credit facility are subject to a 10 basis point fee per annum.

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 and in our Annual Report on Form 10-K, 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 ability to effectively implement our growth strategy, as well as manage growth of our operations and infrastructure, including effective identification and integration of acquisitions;
- variability and length of our sales cycle;
- our ability to accurately forecast results of operations due to certain revenue components being subject to significant fluctuations and an increase in the percentage of our business subject to renewal;
- our ability to reach agreement on a revised multi-year agreement with HCA, Inc. for our Internet-based HLC product;
- our ability to adequately address our customers' needs in products and services;
- the pressure on healthcare organizations and pharmaceutical/medical device companies to reduce costs to customers could result in financial pressures on customers to cut back on our services;
- our ability to maintain and continue our competitive position against current and potential competitors;
- our ability to develop enhancements to our existing products and services, achieve widespread acceptance of new features, or keep pace with technological developments;
- our ability to obtain proper distribution rights from content partners to support growth in courseware subscriptions;
- our ability to achieve profitability on a consistent basis;
- fluctuations in quarterly operating results caused by a variety of factors including the timing of sales, subscription revenue recognition and customer subscription renewals;
- loss of a significant customer and concentration of a significant portion of our revenue with a relatively small number of customers;
- our ability to adequately develop and maintain our network infrastructure, computer systems, software and related security;
- the effect of governmental regulation on us, our business partners and our customers, including, without limitation, changes in federal, state and international laws or other regulations regarding education, training and Internet transactions; and
- other risk factors detailed in our Annual Report on Form 10-K and other filings with the Securities and Exchange Commission.

Overview and Critical Accounting Policies and Estimates

HealthStream was incorporated in 1990 and began marketing its Internet-based solutions in March 1999. The Company focuses on being a facilitator of training and information tools for entities in the healthcare industry. Revenues from the healthcare organizations business unit (HCO) are derived from the following categories: provision of services through our Internet-based HealthStream Learning Center, courseware subscriptions, survey and research services, a variety of complementary online products, and maintenance and support of installed learning management products. Revenues from the pharmaceutical and medical device company business unit (PMD) are derived from live event development, online training and content development, and other educational and training services.

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 that 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.

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
- Product development costs and related capitalization
- Goodwill, intangibles, and other long-lived assets
- Allowance for doubtful accounts
- Stock-based compensation
- Nonmonetary exchanges

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 Annual Report on Form 10-K for the year ended December 31, 2005 filed with the Securities and Exchange Commission, which contains additional information regarding our accounting policies and other disclosures required by US GAAP. On January 1, 2006, we adopted SFAS No. 123(R), “Share-Based Payments” using a modified-prospective approach. Also, as a result of our issuance of service credits in exchange for content rights, we recorded an asset and deferred liability resulting from this nonmonetary transaction. Other than the adoption of Statement 123(R) and our accounting for nonmonetary exchanges, there have been no changes in our critical accounting policies and estimates from those reported in our Annual Report on Form 10-K for the year ended December 31, 2005.

Stock-based Compensation

In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123(R), “Share-Based Payments.” Statement 123(R) supersedes APB Opinion No. 25, “Accounting for Stock Issued to Employees,” (APB 25) and requires companies to recognize compensation expense, using a fair-value based method, for costs related to share-based payments, including stock options. The Company adopted Statement 123(R) on January 1, 2006 and implemented it using the modified-prospective method for transition purposes, therefore prior period financial results have not been restated. The modified-prospective method requires compensation expense be recorded for all unvested share-based payments outstanding prior to adoption and for all share-based payments issued subsequent to adoption using a fair value approach. We use the Black Scholes option pricing model for calculating fair value of our stock-based compensation plans.

Prior to adopting Statement 123(R), we accounted for stock-based compensation arrangements under APB 25, which utilized an intrinsic value approach to recognizing compensation expense. Since we granted stock options with exercise prices equivalent to the market price of our stock on the grant date, our accounting for stock-based compensation under the provisions of APB 25 resulted in nominal compensation expense recorded in our historical financial statements. Prior to January 1, 2006 we disclosed pro-forma financial results under the provisions of SFAS No. 123 “Accounting for Stock-Based Compensation” utilizing the Black Scholes option pricing model. The fair value method used under Statement 123 is similar to the method we will use going forward under Statement 123(R), with the exception that forfeitures will be estimated on the grant date, and adjusted periodically if actual forfeitures vary significantly from our estimates.

During the three and six months ended June 30, 2006, we recorded $228,258 and $377,634 respectively, of stock-based compensation expense resulting from the adoption of Statement 123(R). We typically grant stock options to our management group on an annual basis. We grant stock options to members of our board of directors in conjunction with our annual shareholders meeting. We expect to continue this practice for the foreseeable future. As of June 30, 2006, total future compensation cost related to non-vested awards not yet recognized is $1,270,740, net of estimated forfeitures, with a weighted average expense recognition period of 3.0 years. We estimate that stock-based compensation expense will range between $600,000 and $700,000 for 2006. Actual results could differ from this estimate depending on the timing and size of new awards granted, changes in the market price or volatility of our common stock, changes in risk-free interest rates, or if actual forfeitures vary significantly from our estimates.

Nonmonetary Exchange of Content Rights and Deferred Service Credits

During the three months ended June 30, 2006, we completed updates and maintenance required to publish certain courseware owned by one of our customers and were provided the right to distribute and resell such courseware to our Internet-based customers. In exchange for receipt of an exclusive license to distribute and resell this courseware, we provided the customer with service credits that can be used to make future purchases of our products and services. We accounted for this transaction in accordance with Accounting Principles Board Opinion No. 29 "Accounting for Nonmonetary Transactions." The value assigned to the content rights and the deferred service credits was $904,167, which represents the estimated fair value of the assets relinquished. The content rights are classified within prepaid development fees and other assets, and the service credits are classified within accrued liabilities and other long-term liabilities on our condensed consolidated balance sheet as of June 30, 2006.

The service credits will be issued annually through December 31, 2008 and they expire twenty-four months after issuance, and unused credits will be forfeited. As of June 30, 2006, we are obligated to issue remaining credits of $799,167 through December 31, 2008. Additional service credits may be provided in the future if the customer provides additional courseware rights to us. The content rights are being amortized on a straight-line basis through December 31, 2008. Revenues for services provided in exchange for service credits will be recognized in accordance with our revenue recognition policies.

Business Combination

On March 28, 2005, the Company acquired all of the stock of Data Management & Research, Inc. (DMR) for approximately $10.7 million, consisting of $9.1 million in cash and 479,234 shares of our common stock. The Company also incurred direct, incremental expenses associated with the acquisition of approximately $0.4 million. Of the common stock portion, 319,489 shares were deposited in an escrow account to be held for eighteen months from the acquisition date, subject to any claims for indemnification pursuant to the stock purchase agreement. DMR provides healthcare organizations a wide range of quality and satisfaction surveys, data analyses of survey results, and other research-based measurement tools focused on physicians, patients, and employees.

Revenues and Expense Components

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

Revenues. Revenues for our HCO business unit currently consist of the provision of services through our Internet-based HealthStream Learning Center (HLC), authoring tools, survey and research services, a variety of courseware subscriptions (add-on courseware), maintenance and support services for our installed learning management products, maintenance of content and competency tools. Revenues for our PMD business unit consist of live event development, online training and content development, online sales training courses, live educational activities for nurses and technicians conducted within healthcare organizations, and continuing education activities at association meetings, and HospitalDirect®.

Cost of Revenues (excluding depreciation and amortization). Cost of revenues consists primarily of salaries and employee benefits, stock-based compensation, employee travel and lodging, materials, 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, handle customer support calls or inquiries, manage our web sites, content and survey services, coordinate content maintenance services, and provide training or implementation services.

Product Development. Product development expenses consist primarily of salaries and employee benefits, 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 feature enhancements and new products. Personnel costs within product development include our systems team, product managers, and other personnel associated with content and product development.

Sales and Marketing Expenses. Sales and marketing expenses consist primarily of salaries, commissions and employee benefits, stock-based compensation, employee travel and lodging, advertising, trade shows, promotions, and related marketing costs. Annually, we host a national users' group in Nashville, TN known as "The Summit," the costs of which are included in sales and marketing expenses. Personnel costs within sales and marketing include our sales and marketing team, strategic account management personnel, as well as our account management group. Our account management personnel work to ensure our products and services are fully utilized by our customers, providing consultations with new and prospective customers, as well as supporting the contract renewal process for existing hospital customers.

Depreciation and Amortization. Depreciation and amortization consist of fixed asset depreciation, amortization of intangibles considered to have finite lives, amortization of content or license fees, and amortization of software feature enhancements.

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 and executive management) as well as accreditation professionals.

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 other obligations.

Results of Operations

Financial results for the second quarter of 2006 reflect net income of approximately $289,000. Our financial results for the second quarter of 2006 were significantly impacted by two key events. First, our Sixth Annual Learning Summit, held in April 2006, was attended by approximately 700 participants and vendors and resulted in increased sales and marketing expenses of approximately $150,000 over the second quarter of 2005. Secondly, our PMD business experienced a financial loss on a live event activity, resulting from lower than anticipated revenues and expense overages in production costs. At June 30, 2006, our Internet-based network of healthcare professionals is comprised of 1,309,000 fully implemented subscribers. Key financial indicators for the second quarter of 2006 include:

- Revenues of approximately $8.2 million in the second quarter of 2006, up 21%, or $1.4 million, over second quarter of 2005
- Net income of approximately $289,000 in the second quarter of 2006, compared to $23,000 in the second quarter of 2005
- Earnings per share of $0.01 (basic and diluted) in the second quarter of 2006, compared to $0.00 (basic and diluted) in the second quarter of 2005
- 1,309,000 fully implemented subscribers on our Internet-based HLC at June 30, 2006, up from 1,113,000 at June 30, 2005

Three Months Ended June 30, 2006 Compared to Three Months Ended June 30, 2005

Revenues. Revenues increased approximately $1.4 million, or 20.8%, to $8.2 million for the three months ended June 30, 2006 from $6.8 million for the three months ended June 30, 2005. Revenues for 2006 consisted of $6.4 million for HCO and $1.8 million for PMD. In 2005, revenues consisted of $5.3 million for HCO and $1.5 million for PMD. The increase in HCO revenues was split evenly between growth in the survey and research revenues from the acquisition of DMR totaling $611,000 and an increase of $599,000 from our Internet-based HLC subscriber base. Courseware subscription revenues were comparable to the prior year quarter. Our subscriber base increased approximately 18%, to approximately 1,309,000 fully implemented subscribers at June 30, 2006 from approximately 1,113,000 fully implemented subscribers at June 30, 2005. Revenues from our Internet-based subscription products represented approximately 56% of revenues for the three months ended June 30, 2006 compared to 59% of revenues for the three months ended June 30, 2005. This percentage has decreased since our survey and research products are not fully Internet-based. PMD revenues increased approximately $306,000 over the prior year quarter, primarily associated with our live event business, while revenues from our project-based content development services were comparable to the prior year quarter. We expect third quarter 2006 revenues for PMD to decline compared with the prior year third quarter as a result of declines in our project-based business, primarily associated with declines in our live event business.

Cost of Revenues (excluding depreciation and amortization). Cost of revenues increased approximately $702,000, or 28.6%, to $3.2 million for the three months ended June 30, 2006 from $2.5 million for the three months ended June 30, 2005. Cost of revenues as a percentage of revenues increased to 38.4% of revenues for the three months ended June 30, 2006 from 36.1% of revenues for the three months ended June 30, 2005. This increase is primarily associated with increased expenses associated with our PMD business unit, primarily associated with a loss on a specific live event held during the second quarter of 2006.

Cost of revenues for HCO decreased approximately $162,000 and approximated 20.0% and 27.2% of revenues for the three months ended June 30, 2006 and 2005, respectively. The decline in cost of revenues for HCO resulted from lower personnel expenses and lower royalties paid by us due to changes in the mix of courseware subscription revenues. Our survey and research services have higher direct costs as a percentage of revenues compared to our Internet-based subscription products. Cost of revenues for PMD increased approximately $852,000 over the prior year quarter and approximated 93.6% and 56.8% of revenues for the three months ended June 30, 2006 and 2005, respectively. The increase in cost of revenues for PMD resulted from expense overages in production costs and an overall high cost structure associated with a live event held during the second quarter of 2006, which resulted in a financial loss of approximately $200,000 for the event. For the event, we assumed both greater risk and greater potential reward than our historical contract structures for live event activities. The financial loss resulted from a shortfall in participant registration revenues, in addition to the production cost overages. Due to contract limitations, we were unable pass on the cost overruns to the commercial supporter of the event. We do not anticipate conducting events under similar contract structures in the future.

Gross Margin (excluding depreciation and amortization). Gross margin (which we define as revenues less cost of revenues divided by revenues) decreased to 61.6% for the three months ended June 30, 2006 from 63.9% for the three months ended June 30, 2005. This decline is a result of the increase in cost of revenues discussed above. Gross margins for HCO were 80.0% and 72.8% for the three months ended June 30, 2006 and 2005, respectively. The improvement for HCO resulted from the increase in revenues discussed above. Gross margins for PMD were 6.4% and 43.2% for the three months ended June 30, 2006 and 2005, respectively. The decrease for PMD resulted from the increase in cost of revenues discussed above.

Product development. Product development expenses increased approximately $94,000, or 12.6%, to $837,000 for the three months ended June 30, 2006 from $743,000 for the three months ended June 30, 2005. This increase primarily resulted from personnel expenses associated with additional personnel to support new product development and the ongoing maintenance and operation of our Internet-based platform. New product development efforts primarily consist of additional features and new courseware integration associated with our Internet-based platform. We are currently redesigning our Internet-based HLC platform, and expect to release the new version later this year. Stock-based compensation expense included in product development was approximately $31,000 during the three months ended June 30, 2006 compared to none for the three months ended June 30, 2005. Product development expenses as a percentage of revenues decreased to 10.2% of revenues for the three months ended June 30, 2006 from 10.9% for the three months ended June 30, 2005.

Product development expenses for HCO increased approximately $140,000 compared to the prior year quarter and approximated 11.4% and 11.1% of HCO revenues for the three months ended June 30, 2006 and 2005, respectively. The increase for HCO is associated with additional personnel to support the ongoing maintenance and operation of our Internet-based HLC platform. Product development expenses for PMD decreased modestly compared to the prior year quarter due to lower personnel associated with product management, and approximated 4.0% and 6.2% of PMD revenues for the three months ended June 30, 2006 and 2005, respectively.

Sales and Marketing. Sales and marketing expenses, including personnel costs, increased approximately $432,000, or 26.9%, to $2.0 million for the three months ended June 30, 2006 from $1.6 million for the three months ended June 30, 2005. This increase occurred primarily within our HCO business unit and resulted from increased spending associated with our annual Summit, increases in account management personnel and related travel, as well as increased marketing expenses. The increase in Summit spending resulted from increased attendance and represented approximately $150,000 of the expense increase over the prior year quarter. We also increased our account management team over the past year to address the needs of our larger customers. Stock-based compensation expense included in sales and marketing was approximately $25,000 during the three months ended June 30, 2006 compared to none for the three months ended June 30, 2005. Sales and marketing expenses approximated 24.7% and 23.5% of revenues for the three months ended June 30, 2006 and 2005, respectively.

Sales and marketing expenses for HCO increased $481,000 and approximated 26.1% and 22.4% of revenues for the three months ended June 30, 2006 and 2005, respectively. The increase for HCO is due to the Summit and account management personnel discussed above. Sales and marketing expenses for PMD decreased approximately $51,000, and approximated 15.9% and 22.4% of revenues for the three months ended June 30, 2006 and 2005, respectively. The decrease is due to elimination of a sales management position and related expenses.

Depreciation and Amortization. Depreciation and amortization decreased approximately $93,000, or 12.2%, to $667,000 for the three months ended June 30, 2006 from $760,000 for the three months ended June 30, 2005. The decrease is due to lower depreciation of property and equipment resulting from assets reaching the end of their useful lives.

Other General and Administrative. Other general and administrative expenses increased approximately $125,000, or 9.8%, to $1.4 million for the three months ended June 30, 2006 from $1.3 million for the three months ended June 30, 2005. This increase primarily resulted from stock-based compensation expense associated with the grant of immediately vested stock options to our board of directors during the second quarter of 2006. Other general and administrative expenses as a percentage of revenues decreased to 17.0% for the three months ended June 30, 2006 from 18.7% for the three months ended June 30, 2005. The percentage decrease is a result of the increases in revenues.

Other Income/Expense. Other income/expense increased approximately $85,000, or 124.8%, to income of $152,000 for the three months ended June 30, 2006 from income of $68,000 for the three months ended June 30, 2005. The increase resulted from an increase in interest income from investments in marketable securities, attributable to both increased invested balances and higher rates of return.

(Benefit) Provision for Income Taxes. The income tax benefit of $8,000 during the three months ended June 30, 2006 resulted from deductible compensation resulting from stock option exercises. The Company recorded an income tax provision of $15,000 during the three months ended June 30, 2005, primarily associated with the federal alternative minimum tax.

Net Income. Net income was approximately $289,000 for the three months ended June 30, 2006 compared to $23,000 for the three months ended June 30, 2005. This improvement is a result of the factors mentioned above.

Six Months Ended June 30, 2006 Compared to Six Months Ended June 30, 2005

Revenues. Revenues increased approximately $3.3 million, or 26.1%, to $15.7 million for the six months ended June 30, 2006 from $12.5 million for the six months ended June 30, 2005. Revenues for 2006 consisted of $12.1 million for HCO and $3.6 million for PMD. In 2005, revenues consisted of $9.2 million for HCO and $3.3 million for PMD. The increase in HCO revenues resulted from growth in survey and research services associated with the DMR acquisition totaling $1.9 million, of which approximately $480,000 is the result of organic growth. Revenues from our Internet-based HLC subscriber base increased $1.0 million over the prior year. Courseware subscription revenues were comparable between periods. PMD revenues increased $380,000 over the prior year, primarily associated with increases in revenues from live event services. This increase was partially offset by a decline in project based content development services. On a pro forma basis, taking into consideration the effect of the DMR acquisition as if the acquisition occurred on January 1, 2005, pro forma revenues for the six months ended June 30, 2005 would have been $13.9 million.

Cost of Revenues. Cost of revenues increased approximately $1.2 million, or 27.6%, to $5.7 million for the six months ended June 30, 2006 from $4.5 million for the six months ended June 30, 2005. Cost of revenues as a percentage of revenues increased to 36.4% of revenues for the six months ended June 30, 2006 from 36.0% of revenues for the six months ended June 30, 2005. The increase in cost of revenues resulted from higher direct costs associated with live events during the second quarter of 2006 as well as incremental expenses associated with the increase in survey and research revenues.

Cost of revenues for HCO increased approximately $155,000 and approximated 20.9% and 25.7% of revenues for the six months ended June 30, 2006 and 2005, respectively. Cost of revenue increases for HCO resulted from the additional expenses associated with the increase in survey and research revenues. Cost of revenues for PMD increased by $1.0 million over the prior year and approximated 78.5% and 55.8% of revenues for the six months ended June 30, 2006 and 2005, respectively. The increase for PMD is primarily associated with a live event held during the second quarter of 2006, which resulted in a financial loss of approximately $200,000.

Gross Margin. Gross margin (which we define as revenues less cost of revenues divided by revenues) was 63.6% and 64.0% for the six months ended June 30, 2006 and 2005, respectively. Gross margins for HCO were 79.1% and 74.3% for the six months ended June 30, 2006 and 2005, respectively. Gross margins for PMD were 21.5% and 44.2% for the six months ended June 30, 2006 and 2005, respectively. The significant decline for PMD resulted from the increase in cost of revenues discussed above.

Product development. Product development expenses increased approximately $347,000, or 25.1%, to $1.7 million for the six months ended June 30, 2006 from $1.4 million for the six months ended June 30, 2005. This increase is related to additional personnel expenses and stock-based compensation expense. Product development expenses as a percentage of revenues was 11.0% of revenues for both the six months ended June 30, 2006 and 2005.

Product development expenses for HCO increased approximately $424,000 compared to the prior year and approximated 12.3% and 11.5% of revenues for the six months ended June 30, 2006 and 2005, respectively. The increase for HCO resulted from additional personnel associated with new product development, product management, and the ongoing maintenance and operation of our Internet-based HLC platform. Product development expenses for PMD decreased modestly and approximated 4.6% and 6.1% of revenues for the six months ended June 30, 2006 and 2005, respectively.

Sales and Marketing. Sales and marketing expenses, including personnel costs, increased approximately $870,000, or 31.2%, to $3.7 million for the six months ended June 30, 2006 from $2.8 million for the six months ended June 30, 2005. Sales and marketing expenses approximated 23.3% and 22.4% of revenues for the six months ended June 30, 2006 and 2005, respectively. Sales and marketing expenses for HCO increased approximately $923,000 and approximated 24.1% and 21.6% of revenues for the six months ended June 30, 2006 and 2005, respectively. HCO increases resulted from additional personnel expenses and travel associated with our account management group, increased spending associated with the Summit, incremental expenses associated with DMR personnel, and other marketing expenses. Sales and marketing expenses for PMD decreased modestly and approximated 17.3% and 20.4% of revenues for the six months ended June 30, 2006 and 2005, respectively.

Depreciation and Amortization. Depreciation and amortization decreased approximately $67,000, or 4.9%, to $1.3 million for the six months ended June 30, 2006 from $1.4 million for the six months ended June 30, 2005. The decrease is associated with lower depreciation of property and equipment associated with assets reaching the end of their useful lives, and was partially offset by increased amortization of content and feature enhancements.

Other General and Administrative. Other general and administrative expenses increased approximately $206,000, or 8.5%, to $2.6 million for the six months ended June 30, 2006 from $2.4 million for the six months ended June 30, 2005. This increase is primarily associated with stock-based compensation expense. Other general and administrative expenses as a percentage of revenues decreased to 16.7% for the six months ended June 30, 2005 from 19.4% for the six months ended June 30, 2004. The percentage decrease is a result of the increases in revenues.

Other Income/Expense. Other income/expense increased approximately $121,000, or 72.7%, to $287,000 for the six months ended June 30, 2006 from $166,000 for the six months ended June 30, 2005. The increase resulted from an increase in interest income on investments in marketable securities, attributable to both increased invested balances and higher rates of return.

Net Income. Net income increased $780,000 to $947,000 for the six months ended June 30, 2006 from $167,000 for the six months ended June 30, 2005. This improvement is a result of the factors mentioned above. On a pro forma basis, as if the DMR acquisition occurred on January 1, 2005, pro forma net income would have been $641,000 for the six months ended June 30, 2005.

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 an increasing extent, from revenues generated from the sale of our products and services.

Net cash provided by operating activities was approximately $1.4 million during the six months ended June 30, 2006 compared to $1.2 million during the six months ended June 30, 2005. The significant uses of cash during 2006 include personnel expenses and other direct expenses to support our business and delivery of our products and services, payment of royalties by us to content partners, payments associated with certain live event activities (which we anticipate will be reimbursed during the remainder of 2006), payment of year-end 2005 bonuses to employees, and cash expenditures associated with content and feature enhancements. During the second quarter of 2006, we experienced a loss on a specific live event due to expense overages associated with the event. Because of our contract structure, the expense overages were not reimbursable to us. These uses of cash were offset by cash receipts from customers. Days sales outstanding, or the number of days it takes to collect accounts receivable, improved to approximately 49 days for the six months ended June 30, 2006 from approximately 58 days for the six months ended June 30, 2005. The improvement in days sales outstanding is the result of strong cash receipts during the second quarter of 2006. The Company calculates days sales outstanding by dividing the accounts receivable balance (excluding unbilled and other receivables) by average daily revenues for the period. During the six months ended June 30, 2005, cash generated from operating activities resulted from cash receipts from customers and receipts of commercial support grants which exceeded cash used to fund our operating expenses.

Net cash used in investing activities was approximately $453,000 during the six months ended June 30, 2006 compared to $358,000 during the six months ended June 30, 2005. During 2006, our primary use of cash was for purchases of property and equipment. During 2005, the primary use of cash was for the acquisition of DMR, purchases of investments in marketable securities, and purchases of property and equipment, and was partially offset by the proceeds from sales of investments in marketable securities.

Cash provided by financing activities was approximately $562,000 for the six months ended June 30, 2006 compared to $609,000 during the six months ended June 30, 2005. Cash receipts from both years resulted from stock option exercises and purchases under our Employee Stock Purchase Plan. The decrease from the prior year period primarily related to increased payments associated with capital leases.

As of June 30, 2006, our primary source of liquidity was $13.4 million of cash and cash equivalents, restricted cash, investments in marketable securities, and interest receivable. On July 21, 2006, the Company entered into a revolving credit facility loan agreement with SunTrust Bank for an aggregate principal amount of $7.0 million. The loan matures on July 21, 2009, and bears interest at a variable rate based on the 30 Day LIBOR Rate plus 150 basis points. Unused balances are subject to a 10 basis point commitment fee. The revolving credit facility includes certain financial and other covenants, including a maximum leverage ratio and minimum net tangible worth requirement. As of June 30, 2006, we had no indebtedness other than capital lease obligations.

We believe that our existing cash and cash equivalents, restricted cash, investments in marketable securities, and related interest receivable will be sufficient to meet anticipated cash needs for working capital, new product development and capital expenditures for at least the next 12 months. As part of our growth strategy, we are actively reviewing possible acquisitions that complement our products and services. We anticipate that any acquisitions would be effected through a combination of stock and cash consideration. We may need to raise additional capital through the issuance of equity securities or utilize borrowings under our revolving credit facility to finance any acquisitions. The issuance of stock as consideration for an acquisition would have a dilutive effect and could adversely affect our stock price. There can be no assurance that sources of financing will be available to us on acceptable terms to consummate any acquisitions. Failure to generate sufficient cash flow from operations or raise additional capital when required during or following any potential acquisitions in sufficient amounts and on terms acceptable to us could harm our business, financial condition and results of operations.

Commitments and Contingencies

We expect that capital expenditures and content purchases will range between $2.2 and $2.7 million for the remainder of 2006. We expect to fund these capital expenditures with existing cash and investments, from cash generated from operations, and if needed, from our revolving credit facility. We may also enter into capital lease agreements for some of these asset purchases.

Our strategic alliances have typically provided for payments to content and distribution partners and development partners based on revenues, and we expect to continue similar arrangements in the future. We have capital lease obligations and operating lease commitments for our operating facilities in Nashville, TN, Franklin, TN, and Denver, CO, and a closed facility in Dallas, TX.

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

We are exposed to market risk from changes in interest rates. We do not have any commodity price risk. As of June 30, 2006, we had no outstanding indebtedness other than approximately $381,000 of capital lease obligations, which include fixed interest rates. In the future, we will be exposed to interest rate risk associated with our revolving credit facility, which bears interest at a variable rate based on the 30 Day Libor Rate plus 150 basis points. We are also exposed to market risk with respect to the cash and cash equivalents and marketable securities in which we invest. At July 31, 2006, we had approximately $13.0 million of cash and cash equivalents, restricted cash, investments in marketable securities, and accrued interest that was invested in a combination of short term investments. Current investment rates of return approximate 5.0-5.25%. Assuming a 5.0% rate of return on $13.0 million, a hypothetical 10% decrease in interest rates would decrease interest income and decrease net income on an annualized basis by approximately $65,000.

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*

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 principal 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.

PART II — OTHER INFORMATION

Item 4. *Submission of Matters to a Vote of Security Holders.*

On May 25, 2006, the Company held its Annual Meeting of Shareholders. At the Annual Meeting, the shareholders of the Company elected the following persons as Class III directors to serve until the Annual Meeting of Shareholders in 2009 and until such time as their respective successors are duly elected and qualified, with the number of votes cast for, or withheld as set forth opposite their names.

	Votes	
Nominee	For	Withheld Authority/Abstained
Robert A. Frist, Jr.	18,645,824	25,354
Frank Gordon	18,648,449	22,729
Ronald Hinds	18,576,652	94,526

The shareholders of the Company elected the following person as a Class II director to serve until the Annual Meeting of Shareholders in 2008 and until such time as his successor is duly elected and qualified, with the number of votes cast for, or withheld as set forth opposite his name.

	Votes	
Nominee	For	Withheld Authority/Abstained
Michael Shmerling	18,644,989	26,189

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.

By: /s/ Susan A. Brownie
Susan A. Brownie
Chief Financial Officer
August 11, 2006

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HEALTHSTREAM, INC.

EXHIBIT INDEX

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

Exhibit 31.1

I, Robert A. Frist, Jr., certify that:

1. I have reviewed this quarterly report on Form 10-Q of HealthStream, Inc.;

2. Based on my knowledge, this 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 report;

3. Based on my knowledge, the financial statements, and other financial information included in this 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 report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:

a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, 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 report is being prepared;

b) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

c) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 11, 2006

/s/ ROBERT A. FRIST, JR.
Robert A. Frist, Jr.
Chief Executive Officer

Exhibit 31.2

I, Susan A. Brownie, certify that:

1. I have reviewed this quarterly report on Form 10-Q of HealthStream, Inc.;

2. Based on my knowledge, this 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 report;

3. Based on my knowledge, the financial statements, and other financial information included in this 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 report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:

a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, 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 report is being prepared;

b) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

c) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 11, 2006

/s/ SUSAN A. BROWNIE
Susan A. Brownie
Chief Financial Officer

Exhibit 32.1

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 June 30, 2006, as filed with the Securities and Exchange Commission on the date hereof (the “Report”), Robert A. Frist, Jr., Chief Executive Officer of the Company certifies, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 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, JR.
Robert A. Frist, Jr.
Chief Executive Officer
August 11, 2006

Exhibit 32.2

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 June 30, 2006, as filed with the Securities and Exchange Commission on the date hereof (the “Report”), Susan A. Brownie, Chief Financial Officer of the Company certifies, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 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/ SUSAN A. BROWNIE
Susan A. Brownie
Chief Financial Officer
August 11, 2006