

HEALTHWAYS, INC  
Form 10-Q  
November 08, 2012

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, 2012

or

Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 000-19364

HEALTHWAYS, INC.  
(Exact Name of Registrant as Specified in its Charter)

Delaware  
(State or Other Jurisdiction of  
Incorporation or Organization)

62-1117144  
(I.R.S. Employer  
Identification No.)

701 Cool Springs Boulevard, Franklin, TN 37067  
(Address of Principal Executive Offices) (Zip Code)

615-614-4929  
(Registrant's Telephone Number, Including Area Code)

(Former name, former address and former fiscal year, if  
changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

As of November 2, 2012, there were outstanding 33,931,516 shares of the registrant's common stock, par value \$.001 per share.

Healthways, Inc.  
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## Part I

Item 1. Financial  
Statements

HEALTHWAYS, INC.  
CONSOLIDATED BALANCE SHEETS  
(In thousands)  
(Unaudited)

ASSETS

|   | September 30,<br>2012 | December 31,<br>2011 |
|---|-----------------------|----------------------|
| Current assets:                         |                       |                      |
| Cash and cash equivalents               | \$ 2,571              | \$ 864               |
| Accounts receivable, net                | 103,043               | 97,459               |
| Prepaid expenses                        | 11,624                | 11,417               |
| Other current assets                    | 5,346                 | 1,412                |
| Income taxes receivable                 | 173                   | 6,065                |
| Deferred tax asset                      | 10,115                | 10,314               |
| Total current assets                    | 132,872               | 127,531              |
| Property and equipment:                 |                       |                      |
| Leasehold improvements                  | 38,900                | 41,622               |
| Computer equipment and related software | 284,786               | 239,732              |
| Furniture and office equipment          | 25,275                | 26,324               |
| Capital projects in process             | 10,930                | 17,811               |
|   | 359,891               | 325,489              |
| Less accumulated depreciation           | (205,335)             | (183,301)            |
|   | 154,556               | 142,188              |
| Other assets                            | 20,594                | 10,797               |
| Intangible assets, net                  | 91,572                | 92,997               |
| Goodwill, net                           | 338,744               | 335,392              |
| Total assets                            | \$ 738,338            | \$ 708,905           |

See accompanying notes to the consolidated financial statements.

HEALTHWAYS, INC.  
CONSOLIDATED BALANCE SHEETS  
(In thousands, except share and per share data)  
(Unaudited)

LIABILITIES AND STOCKHOLDERS' EQUITY

|   | September<br>30,<br>2012 | December<br>31,<br>2011 |
|---|--------------------------|-------------------------|
| <b>Current liabilities:</b>                           |                          |                         |
| Accounts payable                                      | \$ 23,809                | \$ 22,578               |
| Accrued salaries and benefits                         | 23,185                   | 35,617                  |
| Accrued liabilities                                   | 33,059                   | 28,639                  |
| Deferred revenue                                      | 6,596                    | 9,273                   |
| Contract billings in excess of earned revenue         | 17,813                   | 13,154                  |
| Current portion of long-term debt                     | 12,132                   | 3,725                   |
| Current portion of long-term liabilities              | 5,642                    | 5,771                   |
| <b>Total current liabilities</b>                      | <b>122,236</b>           | <b>118,757</b>          |
| <br>  |                          |                         |
| Long-term debt  | 281,568                  | 266,117                 |
| Long-term deferred tax liability                      | 31,668                   | 26,964                  |
| Other long-term liabilities                           | 26,370                   | 31,351                  |
| <br>  |                          |                         |
| <b>Stockholders' equity:</b>                          |                          |                         |
| Preferred stock                                       |                          |                         |
| \$.001 par value, 5,000,000 shares                    |                          |                         |
| authorized, none outstanding                          | —                        | —                       |
| Common stock  |                          |                         |
| \$.001 par value, 120,000,000 shares authorized,      |                          |                         |
| 33,914,666 and 33,304,681 shares outstanding,         | 34                       | 33                      |
| respectively  |                          |                         |
| Additional paid-in capital                            | 250,228                  | 247,137                 |
| Retained earnings                                     | 55,937                   | 48,517                  |
| Treasury stock, at cost, 2,254,953 shares in treasury | (28,182)                 | (28,182)                |
| Accumulated other comprehensive loss                  | (1,521)                  | (1,789)                 |
| <b>Total stockholders' equity</b>                     | <b>276,496</b>           | <b>265,716</b>          |
| <br>  |                          |                         |
| <b>Total liabilities and stockholders' equity</b>     | <b>\$ 738,338</b>        | <b>\$ 708,905</b>       |

See accompanying notes to the consolidated financial statements.



HEALTHWAYS, INC.  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
(In thousands, except earnings per share data)  
(Unaudited)

|   | Three Months Ended<br>September 30, |            | Nine Months Ended<br>September 30, |            |
|---|-------------------------------------|------------|------------------------------------|------------|
|   | 2012                                | 2011       | 2012                               | 2011       |
| Revenues  | \$ 166,559                          | \$ 176,206 | \$ 501,990                         | \$ 508,770 |
| Cost of services (exclusive of depreciation and amortization of \$9,158, \$8,973, \$26,689, and \$26,967, respectively, included below) | 126,782                             | 129,588    | 396,321                            | 377,513    |
| Selling, general and administrative expenses  | 14,727                              | 14,185     | 43,455                             | 49,724     |
| Depreciation and amortization   | 13,259                              | 12,467     | 38,233                             | 37,343     |
| Operating income  | 11,791                              | 19,966     | 23,981                             | 44,190     |
| Interest expense  | 3,249                               | 3,221      | 10,822                             | 9,809      |
| Income before income taxes  | 8,542                               | 16,745     | 13,159                             | 34,381     |
| Income tax expense  | 3,514                               | 7,281      | 5,739                              | 15,004     |
| Net income  | \$ 5,028                            | \$ 9,464   | \$ 7,420                           | \$ 19,377  |
| Earnings per share:   |                                     |            |                                    |            |
| Basic   | \$ 0.15                             | \$ 0.28    | \$ 0.22                            | \$ 0.57    |
| Diluted   | \$ 0.15                             | \$ 0.28    | \$ 0.22                            | \$ 0.56    |
| Comprehensive income  | \$ 4,909                            | \$ 9,369   | \$ 7,688                           | \$ 20,037  |
| Weighted average common shares and equivalents:   |                                     |            |                                    |            |
| Basic   | 33,683                              | 33,534     | 33,485                             | 33,815     |
| Diluted   | 34,068                              | 34,178     | 33,706                             | 34,525     |

See accompanying notes to the consolidated financial statements.

HEALTHWAYS, INC.  
CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY  
For the Nine Months Ended September 30, 2012  
(In thousands)  
(Unaudited)

|  | Preferred<br>Stock | Common<br>Stock | Additional<br>Paid-in<br>Capital | Retained<br>Earnings | Treasury<br>Stock | Accumulated<br>Other<br>Comprehensive<br>Loss | Total     |
|--|--------------------|-----------------|----------------------------------|----------------------|-------------------|---|-----------|
| Balance, December 31,<br>2011                                | \$—                | \$33            | \$247,137                        | \$48,517             | \$(28,182)        | \$(1,789)                                     | \$265,716 |
| Comprehensive income   | —                  | —               | —                                | 7,420                | —                 | 268   | 7,688     |
| Exercise of stock options                                    | —                  | 1               | 2,834                            | —                    | —                 | —   | 2,835     |
| Tax effect of stock options<br>and restricted<br>stock units | —                  | —               | (4,453)                          | —                    | —                 | —   | (4,453)   |
| Share-based employee<br>compensation expense                 | —                  | —               | 4,652                            | —                    | —                 | —   | 4,652     |
| Other  | —                  | —               | 58                               | —                    | —                 | —   | 58        |
| Balance, September 30,<br>2012                               | \$—                | \$34            | \$250,228                        | \$55,937             | \$(28,182)        | \$(1,521)                                     | \$276,496 |

See accompanying notes to the consolidated financial statements.



HEALTHWAYS, INC.  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(In thousands)  
(Unaudited)

|   | Nine Months Ended<br>September 30, |           |
|---|------------------------------------|-----------|
|   | 2012                               | 2011      |
| Cash flows from operating activities:   |                                    |           |
| Net income  | \$ 7,420                           | \$ 19,377 |
| Adjustments to reconcile net income to net cash flows provided by operating activities, net of business acquisitions: |                                    |           |
| Depreciation and amortization   | 38,233                             | 37,343    |
| Amortization and write-off of deferred loan costs   | 2,077                              | 1,431     |
| Share-based employee compensation expense   | 4,652                              | 6,803     |
| Deferred income taxes   | (1,517)                            | (2,728)   |
| Excess tax benefits from share-based payment arrangements   | (477)                              | (433)     |
| Increase in accounts receivable, net  | (17,081)                           | (3,554)   |
| Decrease in other current assets  | 779                                | 6,396     |
| Decrease in accounts payable  | (6,029)                            | (588)     |
| Decrease in accrued salaries and benefits   | (14,454)                           | (14,361)  |
| Increase in other current liabilities   | 12,912                             | 9,400     |
| Other   | (3,124)                            | (756)     |
| Net cash flows provided by operating activities   | 23,391                             | 58,330    |
| Cash flows from investing activities:   |                                    |           |
| Acquisition of property and equipment   | (40,735)                           | (33,508)  |
| Business acquisitions, net of cash acquired   | (4,693)                            | (23,523)  |
| Other   | (6,075)                            | (5,085)   |
| Net cash flows used in investing activities   | (51,503)                           | (62,116)  |
| Cash flows from financing activities:   |                                    |           |
| Proceeds from issuance of long-term debt  | 653,874                            | 350,422   |
| Payments of long-term debt  | (631,315)                          | (321,393) |
| Deferred loan costs   | (2,547)                            | —         |
| Excess tax benefits from share-based payment arrangements   | 477                                | 433       |
| Exercise of stock options   | 2,835                              | 4,812     |
| Repurchases of common stock   | —                                  | (23,690)  |
| Change in outstanding checks and other  | 6,471                              | (1,320)   |
| Net cash flows provided by financing activities   | 29,795                             | 9,264     |
| Effect of exchange rate changes on cash   | 24                                 | 94        |
| Net increase in cash and cash equivalents   | 1,707                              | 5,572     |
| Cash and cash equivalents, beginning of period  | 864                                | 1,064     |
| Cash and cash equivalents, end of period  | \$ 2,571                           | \$ 6,636  |

See accompanying notes to the consolidated financial statements.

HEALTHWAYS, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

(1) Basis of Presentation

Our financial statements and accompanying notes are prepared in accordance with accounting principles generally accepted in the United States of America (“U.S. GAAP”). In our opinion, the accompanying consolidated financial statements of Healthways, Inc. and its wholly-owned subsidiaries (“Healthways”, the “Company”, or such terms as “we,” “us,” or “our”) reflect all adjustments consisting of normal, recurring accruals necessary for a fair presentation. We have reclassified certain items in prior periods to conform to current classifications.

We have omitted certain financial information that is normally included in financial statements prepared in accordance with U.S. GAAP but that is not required for interim reporting purposes. You should read the accompanying consolidated financial statements in conjunction with the financial statements and notes thereto included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011.

(2) Recent Accounting Standards

In June 2011, the Financial Accounting Standards Board (the “FASB”) issued Accounting Standards Update (“ASU”) No. 2011-05, “Presentation of Comprehensive Income”. This standard eliminates the option to report other comprehensive income and its components in the statement of changes in stockholders’ equity and requires an entity to present net income and other comprehensive income in one continuous statement or in two separate but consecutive statements. In December 2011, the FASB issued ASU No. 2011-12, “Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05”, which defers the requirement to present on the face of the financial statements reclassification adjustments for items that are reclassified from other comprehensive income to net income while the FASB further deliberates this aspect of the proposal. ASU No. 2011-05, as amended by ASU No. 2011-12, is effective for interim and annual reporting periods beginning after December 15, 2011. We adopted this standard for the interim period beginning January 1, 2012 and elected to present net income and other comprehensive income in one continuous statement. The adoption of this standard did not have an impact on our consolidated results of operations, financial position, cash flows, or notes to the consolidated financial statements.

In July 2012, the FASB issued ASU No. 2012-02, “Intangibles—Goodwill and Other (Topic 350)—Testing Indefinite-Lived Intangible Assets for Impairment”. ASU No. 2012-02 permits an entity to perform a qualitative assessment to determine whether it is more likely than not that the fair value of an indefinite-lived intangible asset is less than its carrying value. If the entity concludes that this is the case, it must perform the currently prescribed quantitative impairment test by comparing the fair value of the indefinite-lived intangible asset with its carrying value. Otherwise, the quantitative impairment test is not required. ASU No. 2012-02 is effective for fiscal years beginning after September 15, 2012, with earlier adoption permitted. We do not expect the adoption of this standard to have a material impact on our consolidated results of operations, financial position, cash flows, or notes to the consolidated financial statements.

(3) Share-Based Compensation

We have several stockholder-approved stock incentive plans for our employees and directors. We currently have three types of share-based awards outstanding under these plans: stock options, restricted stock



units, and restricted stock. We believe that such awards align the interests of our employees and directors with those of our stockholders.

For the three and nine months ended September 30, 2012, we recognized share-based compensation costs of \$1.9 million and \$4.7 million, respectively. For the three and nine months ended September 30, 2011, we recognized share-based compensation costs of \$2.3 million and \$6.8 million, respectively.

A summary of our stock options as of September 30, 2012 and changes during the nine months then ended is presented below:

| Options                              | Shares<br>(000s) | Weighted-<br>Average<br>Exercise<br>Price | Weighted-<br>Average<br>Remaining<br>Contractual<br>Term<br>(years) | Aggregate<br>Intrinsic<br>Value<br>(\$000s) |
|--------------------------------------|------------------|---|---|---|
| Outstanding at January 1,<br>2012    | 5,659            | \$ 17.58                                  |   |   |
| Granted                              | 837              | 7.75                                      |   |   |
| Exercised                            | (401)            | 7.23                                      |   |   |
| Forfeited                            | (584)            | 10.60                                     |   |   |
| Expired                              | (690)            | 30.27                                     |   |   |
| Outstanding at September<br>30, 2012 | 4,821            | 15.77                                     | 5.68  | \$4,770                                     |
| Exercisable at September 30,<br>2012 | 2,696            | 20.02                                     | 3.46  | \$445                                       |

The weighted-average grant-date fair value of options granted during the three and nine months ended September 30, 2012 was \$5.10 and \$3.97, respectively.

The following table shows a summary of our restricted stock and restricted stock units (“nonvested shares”) as of September 30, 2012, as well as activity during the nine months then ended:

| Nonvested Shares                   | Shares<br>(000s) | Weighted-<br>Average<br>Grant Date<br>Fair Value |
|------------------------------------|------------------|--|
| Nonvested at January 1,<br>2012    | 910              | \$ 12.22   |
| Granted                            | 404              | 7.38   |
| Vested                             | (264)            | 12.61  |
| Forfeited                          | (168)            | 10.75  |
| Nonvested at September 30,<br>2012 | 882              | \$ 9.83  |

#### (4) Income Taxes

Our effective tax rate decreased to 41.1% for the three months ended September 30, 2012 compared to 43.5% for the three months ended September 30, 2011, primarily due to a favorable impact on the effective tax rate related to routine reconciliations of tax return filings as well as a favorable impact from the higher relative level of foreign earnings,

which are taxed at statutory rates lower than our domestic earnings.

Our effective tax rate remained relatively consistent for the nine months ended September 30, 2012 compared to the nine months ended September 30, 2011.

We file income tax returns in the U.S. federal jurisdiction and in various state and foreign jurisdictions. Tax years remaining subject to examination in these jurisdictions include 2008 to present.

(5) Derivative Investments and Hedging  
Activities

We use derivative instruments to manage risks related to interest rates and foreign currencies. We record all derivatives at estimated fair value as either assets or liabilities on the consolidated balance sheets and recognize the unrealized gains and losses in either the consolidated balance sheets or consolidated statements of comprehensive income, depending on whether the derivative is designated as a hedging instrument. As permitted under our master netting agreements, the fair value amounts of our derivative instruments are presented on a net basis by counterparty in the consolidated balance sheets.

Interest Rate

In order to reduce our exposure to interest rate fluctuations on our floating rate debt commitments, we maintain interest rate swap agreements that effectively modify our exposure to interest rate risk by converting a portion of our floating rate debt to fixed obligations, thus reducing the impact of interest rate changes on future interest expense. Under these agreements, we receive a variable rate of interest based on LIBOR, and we pay a fixed rate of interest with interest rates ranging from 0.370% to 3.385% plus a spread (see Note 7). We maintain interest rate swap agreements with current notional amounts of \$475.0 million and termination dates ranging from December 31, 2012 to December 31, 2016. Of this amount, \$200.0 million will become effective in 2013, and \$50.0 million in 2015, as older interest rate swap agreements expire. We have designated these interest rate swap agreements as qualifying cash flow hedges. We currently meet the hedge accounting criteria under U.S. GAAP in accounting for these interest rate swap agreements.

Foreign Currency

We enter into foreign currency options and/or forward contracts in order to minimize our earnings exposure to fluctuations in foreign currency exchange rates. Our foreign currency exchange contracts do not qualify for hedge accounting treatment under U.S. GAAP. We routinely monitor our foreign currency exposures to maximize the overall effectiveness of our foreign currency hedge positions. We do not execute transactions or hold derivative financial instruments for trading or other purposes.

Fair Values of Derivative Instruments

The estimated gross fair values of derivative instruments at September 30, 2012 and December 31, 2011, excluding the impact of netting derivative assets and liabilities when a legally enforceable master netting agreement exists, were as follows:

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| (In \$000s)  | September 30, 2012                           |                                     | December 31, 2011                            |                                     |
|--|--|-------------------------------------|--|-------------------------------------|
|  | Foreign<br>currency<br>exchange<br>contracts | Interest rate<br>swap<br>agreements | Foreign<br>currency<br>exchange<br>contracts | Interest rate<br>swap<br>agreements |
| <b>Assets:</b>                                     |  |                                     |  |                                     |
| Derivatives not designated as hedging instruments: |  |                                     |  |                                     |
| Other current assets                               | \$115  | \$—                                 | \$315  | \$—                                 |
| <b>Total assets</b>                                | <b>\$115</b>                                 | <b>\$—</b>                          | <b>\$315</b>                                 | <b>\$—</b>                          |
| <b>Liabilities:</b>                                |  |                                     |  |                                     |
| Derivatives not designated as hedging instruments: |  |                                     |  |                                     |
| Accrued liabilities                                | \$280  | \$—                                 | \$321  | \$—                                 |
| Derivatives designated as hedging instruments:     |  |                                     |  |                                     |
| Accrued liabilities                                | —  | 173                                 | —  | 251                                 |
| Other long-term liabilities                        | —  | 3,484                               | —  | 3,984                               |
| <b>Total liabilities</b>                           | <b>\$280</b>                                 | <b>\$3,657</b>                      | <b>\$321</b>                                 | <b>\$4,235</b>                      |

Cash Flow Hedges

Derivative instruments that are designated and qualify as cash flow hedges are recorded at estimated fair value in the consolidated balance sheets, with the effective portion of the gains and losses being reported in accumulated other comprehensive income or loss (“accumulated OCI”). Cash flow hedges for all periods presented consist solely of interest rate swap agreements. Gains and losses on these interest rate swap agreements are reclassified to interest expense in the same period during which the hedged transaction affects earnings or the period in which all or a portion of the hedge becomes ineffective. As of September 30, 2012, we expect to reclassify \$2.4 million of net losses on interest rate swap agreements from accumulated OCI to interest expense within the next 12 months due to the scheduled payment of interest associated with our debt.

The following table shows the effect of our cash flow hedges on the consolidated balance sheets during the three and nine months ended September 30, 2012 and September 30, 2011:

| (In \$000s)   | For the Three Months Ended |                       | For the Nine Months Ended |                       |
|---|----------------------------|-----------------------|---------------------------|-----------------------|
|   | September<br>30, 2012      | September<br>30, 2011 | September<br>30, 2012     | September<br>30, 2011 |
| Derivatives in Cash Flow Hedging Relationships  |                            |                       |                           |                       |
| Loss related to effective portion of derivatives recognized in accumulated OCI, gross of tax effect                         | \$1,223                    | \$572                 | \$2,001                   | \$1,983               |
| Loss related to effective portion of derivatives reclassified from accumulated OCI to interest expense, gross of tax effect | \$790                      | \$1,160               | \$2,579                   | \$3,631               |

Gains and losses representing either hedge ineffectiveness or hedge components excluded from the assessment of effectiveness are recognized in current earnings. During the three and nine months ended September 30, 2012 and



2011, there were no gains or losses on cash flow hedges recognized in our consolidated statements of comprehensive income resulting from hedge ineffectiveness.

#### Derivative Instruments Not Designated as Hedging Instruments

Our foreign currency exchange contracts require current period mark-to-market accounting, with any change in fair value being recorded each period in the consolidated statements of comprehensive income in

selling, general and administrative expenses. At September 30, 2012, we had forward contracts with notional amounts of \$13.7 million to exchange foreign currencies, primarily the Australian dollar and Euro, that were entered into in order to hedge forecasted foreign net income (loss) and intercompany debt.

These forward contracts did not have a material effect on our consolidated statements of comprehensive income during the three or nine months ended September 30, 2012 and 2011.

#### (6) Fair Value Measurements

We account for certain assets and liabilities at fair value. Fair value is defined as the price that would be received upon sale of an asset or paid upon transfer of a liability in an orderly transaction between market participants at the measurement date, assuming the transaction occurs in the principal or most advantageous market for that asset or liability.

#### Fair Value Hierarchy

The hierarchy below lists three levels of fair value based on the extent to which inputs used in measuring fair value are observable in the market. We categorize each of our fair value measurements in one of these three levels based on the lowest level input that is significant to the fair value measurement in its entirety. These levels are:

Level 1: Quoted prices in active markets for identical assets or liabilities;

Level 2: Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-based valuation techniques in which all significant assumptions are observable in the market or can be corroborated by observable market data for substantially the full term of the assets or liabilities; and

Level 3: Unobservable inputs that are supported by little or no market activity and typically reflect management's estimates of assumptions that market participants would use in pricing the asset or liability.

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

The following tables present our assets and liabilities measured at fair value on a recurring basis at September 30, 2012 and December 31, 2011:

| (In \$000s)                         | Level  | Gross  | Netting  | Net    |
|-------------------------------------|--------|--------|----------|--------|
| September 30, 2012                  | 2      | Fair   | (1)      | Fair   |
| Assets:                             |        | Value  |          | Value  |
| Foreign currency exchange contracts | \$ 115 | \$ 115 | \$ (109) | \$ 6   |
| Liabilities:                        |        |        |          |        |
| Foreign currency exchange contracts | \$ 280 | \$ 280 | \$ (109) | \$ 171 |
| Interest rate swap agreements       | 3,657  | 3,657  | —        | 3,657  |

| (In \$000s)                         | Level  | Gross      | Netting  | Net        |
|-------------------------------------|--------|------------|----------|------------|
| December 31, 2011                   | 2      | Fair Value | (1)      | Fair Value |
| <b>Assets:</b>                      |        |            |          |            |
| Foreign currency exchange contracts | \$ 315 | \$ 315     | \$ (212) | \$ 103     |
| <b>Liabilities:</b>                 |        |            |          |            |
| Foreign currency exchange contracts | \$ 321 | \$ 321     | \$ (212) | \$ 109     |
| Interest rate swap agreements       | 4,235  | 4,235      | —        | 4,235      |

(1) This column reflects the impact of netting derivative assets and liabilities by counterparty when a legally enforceable master netting agreement exists.

The fair values of forward foreign currency exchange contracts are valued using broker quotations of similar assets or liabilities in active markets. The fair values of interest rate swap agreements are primarily determined based on the present value of future cash flows using internal models and third-party pricing services with observable inputs, including interest rates, yield curves and applicable credit spreads.

#### Fair Value of Other Financial Instruments

In addition to foreign currency exchange contracts and interest rate swap agreements, the estimated fair values of which are disclosed above, the estimated fair value of each class of financial instruments at September 30, 2012 was as follows:

- Cash and cash equivalents – The carrying amount of \$2.6 million approximates fair value because of the short maturity of those instruments (less than three months).
- Long-term debt – The estimated fair value of outstanding borrowings under the Fifth Amended and Restated Revolving Credit and Term Loan Agreement (the “Fifth Amended Credit Agreement”), which includes a revolving credit facility and a term loan facility (see Note 7), is determined based on the fair value hierarchy as discussed above. The revolving credit facility and the term loan facility are not actively traded and therefore are classified as Level 2 valuations based on the market for similar instruments. The estimated fair value is based on the average of the prices set by the issuing bank given current market conditions and is not necessarily indicative of the amount we could realize in a current market exchange. The estimated fair value and carrying amount of outstanding borrowings under the Fifth Amended Credit Agreement at September 30, 2012 are \$289.6 million and \$290.3 million, respectively. Under the Fourth Amended and Restated Credit Agreement, which was in effect through June 7, 2012, the term loan was actively traded and was classified as a Level 1 valuation based on the market for identical instruments.

#### (7) Long-Term Debt

On June 8, 2012, we entered into the Fifth Amended Credit Agreement. The Fifth Amended Credit Agreement provides us with a \$200.0 million revolving credit facility that expires June 8, 2017 and includes a swingline sub facility of \$20.0 million and a \$75.0 million sub facility for letters of credit. The Fifth Amended Credit Agreement also provides a \$200.0 million term loan facility that matures on June 8, 2017, all of which remained outstanding on September 30, 2012, and an uncommitted incremental accordion facility of \$200.0 million. As of September 30, 2012, availability under the revolving credit facility totaled \$71.9 million as calculated under the most restrictive covenant.



Borrowings under the Fifth Amended Credit Agreement generally bear interest at variable rates based on a margin or spread in excess of either (1) the one-month, two-month, three-month or six-month rate (or with the approval of affected lenders, nine-month or twelve-month rate) for Eurodollar deposits ( "LIBOR") or (2) the greatest of (a) the prime lending rate, (b) the federal funds rate plus 0.50%, and (c) one-month LIBOR plus 1.00% (the "Base Rate"), as selected by the Company. The LIBOR margin varies between 1.75% and 3.00%, and the Base Rate margin varies between 0.75% and 2.00%. The Fifth Amended Credit Agreement also provides for an annual fee ranging between 0.30% and 0.50% of the unused commitments under the revolving credit facility. The Fifth Amended Credit Agreement is secured by guarantees from all of the Company's active domestic subsidiaries and by security interests in substantially all of the Company's and such subsidiaries' assets.

We are required to repay outstanding revolving loans under the revolving credit facility on June 8, 2017. We are required to repay term loans in quarterly principal installments aggregating (1) 1.250% of the original aggregate principal amount of the term loans during each of the first eight quarters following the closing, (2) 1.875% of the original aggregate principal amount of the term loans during each of the next four quarters following the closing, (3) 2.500% of the original aggregate principal amount of the term loans during each of the remaining quarters prior to maturity on June 8, 2017, at which time the entire unpaid principal balance of the term loans is due and payable.

The Fifth Amended Credit Agreement contains various financial covenants, which require us to maintain, as defined therein, ratios or levels of 1) total funded debt to EBITDA and 2) fixed charge coverage. The Fifth Amended Credit Agreement also limits the amount of dividends and repurchases of the Company's common stock. As of September 30, 2012, we were in compliance with all of the covenant requirements of the Fifth Amended Credit Agreement.

As described in Note 5 above, as of September 30, 2012, we are a party to interest rate swap agreements for which we receive a variable rate of interest based on LIBOR and for which we pay a fixed rate of interest.

#### (8) Restructuring and Related Charges

In November 2011, we began a restructuring of the Company (the "2011 Restructuring"), which was largely completed by the end of fiscal 2011, primarily focused on aligning our capacity requirements and organizational structure following CIGNA's decision to wind-down its contract beginning in 2012. We do not expect to incur significant additional costs or adjustments related to this restructuring.

In November 2010, we began a restructuring of the Company (the "2010 Restructuring"), which was largely completed by the end of fiscal 2010, primarily focused on aligning resources with current and emerging markets and consolidating operating capacity. We do not expect to incur significant additional costs or adjustments related to this restructuring.

The change in accrued restructuring and related charges associated with the 2011 Restructuring and 2010 Restructuring activities described above during the nine months ended September 30, 2012 were as follows:

| (In 000s)   | 2011<br>Restructuring | 2010<br>Restructuring | Total     |
|---|-----------------------|-----------------------|-----------|
| Accrued restructuring and related charges at January 1, 2012    | \$ 8,426              | \$ 1,583              | \$ 10,009 |
| Payments  | (6,935)               | (608)                 | (7,543)   |
| Adjustments (1)   | (502)                 | (102)                 | (604)     |
| Accrued restructuring and related charges at September 30, 2012 | \$ 989                | \$ 873                | 1,862     |

(1) Adjustments for the nine months ended September 30, 2012 resulted primarily from actual employee tax and benefit amounts differing from previous estimates.

#### (9) Commitments and Contingencies

##### Contract Dispute

We currently are involved in a contractual dispute with Blue Cross Blue Shield of Minnesota regarding fees paid to us as part of a former contractual relationship. On January 25, 2010, Blue Cross Blue Shield of Minnesota issued notice of arbitration with the American Arbitration Association in Minneapolis alleging a violation of certain contract provisions. We believe we performed our services in compliance with the terms of our agreement and that the assertions made in the arbitration notice are without merit. On August 3, 2011, we asserted numerous counterclaims against Blue Cross Blue Shield of Minnesota. We are not able to reasonably estimate a range of potential losses, if any.

##### Anti-Trust Lawsuit

On May 1, 2012, American Specialty Health Group (“ASH”) amended a claim (the “Amended Claim”) that it had previously filed against the Company in the U.S. District Court in the Southern District of California (“Court”) on December 2, 2011 (the “Original Claim”). The Original Claim alleged that the Company’s exclusivity provisions in some of its contracts with participating locations in its SilverSneakers fitness network violate California’s Unfair Competition Law (“UCL”) and that the Company interfered with ASH’s contractual relations and prospective economic advantages. The Amended Claim added allegations that the Company is in violation of the Sherman Antitrust Act (the “Act”) because such exclusivity provisions create illegal restraints on trade and constitute monopolization or attempted monopolization in violation of the Act. Under the Amended Claim, ASH is seeking damages in excess of \$15,000,000, treble damages under the Act, and injunctive relief. The Company has asserted counterclaims against ASH for interference and violation of the UCL, and on October 12, 2012, the Court granted the Company’s motion to add an additional counterclaim that ASH has falsely advertised the composition of its fitness facility network in violation of the Lanham Act.

We believe ASH’s claims are without merit and intend to vigorously defend ourselves against the Amended Claim.

##### Performance Award Lawsuit

On September 4, 2012, Milton Pfeiffer (“Plaintiff”), claiming to be a stockholder of the Company, filed a putative derivative action against the Company and the Board of Directors in Delaware Chancery Court



alleging that the Compensation Committee and the Board of Directors breached their fiduciary duties and violated the Company's 2007 Stock Incentive Plan (the "Plan") by granting Ben R. Leedle, Jr., Chief Executive Officer and President of the Company, a discretionary performance award under the Plan of 500,000 shares (the "Performance Award"), which consisted of 365,000 performance awards issued in November 2011 and 135,000 performance awards issued in February 2012. Plaintiff alleges that the Performance Award exceeded what is authorized by the Plan and that the Company's 2012 proxy statement, in which the Performance Award is disclosed, is false and misleading. Plaintiff also alleges that Mr. Leedle breached his fiduciary duties and was unjustly enriched by receiving the Performance Award. Plaintiff is seeking, inter alia, the rescission or disgorgement of all alleged "excess" awards granted to Mr. Leedle under the Performance Award, to recover any incidental damages to the Company, and an award of attorneys' fees and expenses. We believe Plaintiff's claims are without merit and intend to vigorously defend ourselves against the action.

## Outlook

We are also subject to other contractual disputes, claims and legal proceedings that arise from time to time in the ordinary course of our business. While we are unable to estimate a range of potential losses, we do not believe that any of the legal proceedings pending against us as of the date of this report will have a material adverse effect on our liquidity or financial condition. As these matters are subject to inherent uncertainties, our view of these matters may change in the future.

## Contractual Commitment

In May 2011, we entered into a ten-year applications and technology services outsourcing agreement with HP Enterprise Services, LLC that contains minimum fee requirements. Total payments over the remaining term, including an estimate for future contractual cost of living adjustments, must equal or exceed a minimum level of approximately \$166.8 million; however, based on initial required service and equipment level assumptions, we estimate that the remaining payments will be approximately \$342.8 million. The agreement allows us to terminate all or a portion of the services after the first two years provided we pay certain termination fees, which could be material to the Company.

## (10) Share Repurchases

The Company's Board of Directors authorized a share repurchase program, which was publicly announced on October 21, 2010. The share repurchase program allows for the repurchase of up to \$60 million of our common stock from time to time in the open market or in privately negotiated transactions through October 19, 2012. No shares were repurchased between July 1, 2012 and September 30, 2012 pursuant to the program.

| Period                    | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs |
|---------------------------|----------------------------------|------------------------------|--|--|
| July 1 through 31, 2012   | —                                | —                            | 2,254,953  | \$31,813,383   |
| August 1 through 31, 2012 | —                                | —                            | 2,254,953  | \$31,813,383   |
|                           | —                                | —                            | 2,254,953  | \$31,813,383   |



September 1 through 30,  
2012

Total

—

17

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## (11) Earnings Per Share

The following is a reconciliation of the numerator and denominator of basic and diluted earnings per share for the three and nine months ended September 30, 2012 and 2011:

| (In 000s, except per share data)  | Three Months Ended |          | Nine Months Ended |           |
|---|--------------------|----------|-------------------|-----------|
|   | September 30,      |          | September 30,     |           |
|   | 2012               | 2011     | 2012              | 2011      |
| <b>Numerator:</b>   |                    |          |                   |           |
| Net income - numerator for basic earnings per share   | \$ 5,028           | \$ 9,464 | \$ 7,420          | \$ 19,377 |
| <b>Denominator:</b>   |                    |          |                   |           |
| Shares used for basic earnings per share  | 33,683             | 33,534   | 33,485            | 33,815    |
| Effect of dilutive securities outstanding:  |                    |          |                   |           |
| Non-qualified stock options   | 127                | 322      | 50                | 379       |
| Restricted stock units  | 258                | 322      | 171               | 331       |
| Shares used for diluted earnings per share  | 34,068             | 34,178   | 33,706            | 34,525    |
| <b>Earnings per share:</b>  |                    |          |                   |           |
| Basic   | \$ 0.15            | \$ 0.28  | \$ 0.22           | \$ 0.57   |
| Diluted   | \$ 0.15            | \$ 0.28  | \$ 0.22           | \$ 0.56   |
| Dilutive securities outstanding not included in the computation of earnings per share because their effect is antidilutive: |                    |          |                   |           |
| Non-qualified stock options   | 4,339              | 4,082    | 5,146             | 4,234     |
| Restricted stock units  | 124                | 183      | 236               | 138       |

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

### Overview

Founded in 1981, Healthways provides specialized, comprehensive solutions to help people improve physical, emotional and social well-being, thereby improving their health and productivity and reducing their health-related costs.

We provide highly specific and personalized interventions for each individual in a population, irrespective of health status, age or payor. Our evidence-based health, prevention and well-being services are made available to consumers via phone, mobile devices, direct mail, the Internet, face-to-face consultations and venue-based interactions.

In North America, our customers include health plans, employers, integrated healthcare systems, hospitals, physicians, and government entities in all 50 states, the District of Columbia and Puerto Rico. We also provide services to commercial healthcare businesses and/or government entities in Brazil, Australia and France. We operate domestic and international well-being improvement centers staffed with licensed health professionals. Our fitness center network encompasses approximately 15,000 U.S. locations. We also maintain an extensive network of over 88,000 complementary, alternative and physical medicine practitioners, which offers convenient access to the significant number of individuals who seek health services outside of the traditional healthcare system.

Our guiding philosophy and approach to market is predicated on the fundamental belief that healthier people cost less and are more productive. As described more fully below, our programs are designed to improve well-being by helping people to adopt or maintain healthy behaviors, reduce health-related risk factors, and optimize care for identified health conditions.

First, our programs are designed to help people adopt or maintain healthy behaviors by:

- fostering wellness and disease prevention through total population screening, well-being assessments and supportive interventions; and
- providing access to health improvement programs, such as fitness solutions, weight management, chiropractic, and complementary and alternative medicine.

Our prevention programs focus on education, physical fitness, health coaching, and behavior change techniques and support. We believe this approach improves the well-being status of member populations and reduces the short- and long-term health-related costs for participants, including associated costs from the loss of employee productivity.

Second, our programs are designed to help people reduce health-related risk factors by:

- promoting the change and improvement of the lifestyle behaviors that lead to poor health or chronic conditions; and
- providing educational materials and personal interactions with highly trained nurses and other healthcare professionals to create and sustain healthier behaviors for those individuals at-risk or in the early stages of chronic conditions.

We enable our customers to engage everyone in their covered populations through specific interactions that are sensitive to each individual's health risks and needs. Our programs are designed to motivate people to make positive lifestyle changes and accomplish individual goals, such as increasing physical activity for seniors through the Healthways SilverSneakers fitness solution, overcoming nicotine addiction through the QuitNet® on-line smoking cessation community, or generating sustainable weight-loss through our Innergy™ solution.

Finally, our programs are designed to help people optimize care for identified health conditions by:

- incorporating the latest, evidence-based clinical guidelines into interventions to optimize patient health outcomes;
  - developing care support plans and motivating members to set attainable goals for themselves;
  - providing local market resources to address acute episodic interventions;
  - coordinating members' care with their healthcare providers;
- providing software licensing and management consulting in support of well-being improvement services; and
- providing high-risk care management for members at risk for hospitalization due to complex conditions.

Our approach is to use proprietary, analytic models to identify individuals who are likely to incur future high costs, including those who have specific gaps in care, and through evidence-based interventions drive adherence to proven standards of care, medication regimens and physicians' plans of care to reduce disease progression and related medical spending.

We recognize that each individual plays a variety of roles in his or her pursuit of health, often simultaneously. By providing the full spectrum of services to meet each individual's needs, we believe our interventions can be delivered at scale and in a manner that reflects those unique needs over time. We believe creating real and sustainable behavior change generates measurable, long-term cost savings and improved individual and business performance.

#### Forward-Looking Statements

Management's Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements, which are based upon current expectations, involve a number of risks and uncertainties, and are subject to the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements include all statements that are not historical statements of fact and those regarding the intent, belief, or expectations of the Company, including, without limitation, all statements regarding the Company's future earnings and results of operations, and can be identified by the use of words like "may," "believe," "will," "expect," "project," "estimate," "anticipate," or "continue" and similar expressions. Those forward-looking statements may be affected by certain risks and uncertainties, including, but not limited to:

- our ability to sign and implement new contracts for our solutions;
- our ability to accurately forecast the costs required to successfully implement new contracts;
- our ability to renew and/or maintain contracts with our customers under existing terms or restructure these contracts on terms that would not have a material negative impact on our results of operations;
- our ability to effectively compete against other entities, whose financial, research, staff, and marketing resources may exceed our resources;
- our ability to accurately forecast the Company's revenues, margins, earnings and net income, as well as any potential charges that we may incur as a result of changes in our business;

- our ability to accurately forecast variables that affect performance and the timing of revenue recognition under the terms of our customer contracts ahead of data collection and reconciliation;
- the impact of the Patient Protection and Affordable Care Act, as amended by the Health Care and Education Reconciliation Act of 2010 (“PPACA”), on our operations and/or the demand for our services;
- the impact of any new or proposed legislation, regulations and interpretations relating to the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, including the potential expansion to Phase II for Medicare Health Support programs and any legislative or regulatory changes with respect to Medicare Advantage;
  - our ability to anticipate the rate of market acceptance of our solutions in potential international markets;
  - our ability to accurately forecast the costs necessary to establish a presence in international markets;
- the risks associated with foreign currency exchange rate fluctuations and our ability to hedge against such fluctuations;
- the risks associated with deriving a significant concentration of our revenues from a limited number of customers;
- our ability to achieve and reach mutual agreement with customers with respect to contractually required performance metrics, cost savings and clinical outcomes improvements, or to achieve such metrics, savings and improvements within the time frames contemplated by us;
- our ability to achieve estimated annualized revenue in backlog in the manner and within the timeframe we expect, which is based on certain estimates regarding the implementation of our services;
- our ability and/or the ability of our customers to enroll participants and to estimate their level of enrollment and participation in our programs in a manner and within the timeframe anticipated by us;
  - the ability of our customers to provide timely and accurate data that is essential to the operation and measurement of our performance under the terms of our contracts;
  - our ability to favorably resolve contract billing and interpretation issues with our customers;
- our ability to service our debt, make principal and interest payments as those payments become due, and remain in compliance with our debt covenants;
- the risks associated with changes in macroeconomic conditions, which may reduce the demand and/or the timing of purchases for our services from customers or potential customers, reduce the number of covered lives of our existing customers, or restrict our ability to obtain additional financing;
  - counterparty risk associated with our interest rate swap agreements and foreign currency exchange contracts;
- our ability to integrate acquired businesses, services (including outsourced services), or technologies into our business and to accurately forecast the related costs;
- our ability to anticipate and respond to strategic changes, opportunities, and trends in our industry and/or business and to accurately forecast the related impact on our earnings;
  - the impact of any impairment of our goodwill or other intangible assets;
  - our ability to develop new products and deliver outcomes on those products;
- our ability to implement our integrated data and technology solutions platform within the required timeframe and expected cost estimates and to develop and enhance this platform and/or other technologies to meet evolving customer and market needs;
- our ability to obtain adequate financing to provide the capital that may be necessary to support our operations and to support or guarantee our performance under new contracts;
- unusual and unforeseen patterns of healthcare utilization by individuals with diseases or conditions for which we provide services;
- the ability of our customers to maintain the number of covered lives enrolled in the plans during the terms of our agreements;
  - the impact of legal proceedings involving us and/or our subsidiaries;

- the impact of future state, federal, and international legislation and regulations applicable to our business, including PPACA, on our ability to deliver our services and on the financial health of our customers and their willingness to purchase our services;
- current geopolitical turmoil, the continuing threat of domestic or international terrorism, and the potential emergence of a health pandemic; and
- other risks detailed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011 and other filings with the Securities and Exchange Commission.

We undertake no obligation to update or revise any such forward-looking statements.

#### Contract Terms

Our fees are generally billed on a per member per month (“PMPM”) basis or upon member participation. For PMPM fees, we generally determine our contract fees by multiplying the contractually negotiated PMPM rate by the number of members covered by our services during the month. We typically set PMPM rates during contract negotiations with customers based on the value we expect our programs to create and a sharing of that value between the customer and the Company. In addition, some of our services, such as the Healthways SilverSneakers fitness solution, include fees that are based upon member participation.

Our contracts with health plans generally range from three to five years with provisions for subsequent renewal; contracts with self-insured employers typically have one to three-year terms. Some of our contracts allow the customer to terminate early.

Some of our contracts place a portion of our fees at risk based on achieving certain performance metrics, cost savings, and/or clinical outcomes improvements (“performance-based”). Approximately 7% of revenues recorded during the nine months ended September 30, 2012 were performance-based and were subject to final reconciliation as of September 30, 2012.

#### Technology

Our solutions require sophisticated analytical, data management, Internet and computer-telephony solutions based on state-of-the-art technology. These solutions help us deliver our services to large populations within our customer base. Our predictive modeling capabilities allow us to identify and stratify those participants who are most at risk for an adverse health event. We incorporate behavior-change science with consumer-friendly interactions to facilitate consumer preferences for engagement and convenience. We use sophisticated data analytical and reporting solutions to validate the impact of our programs on clinical and financial outcomes. We continue to invest heavily in technology, as evidenced by our long-term applications and technology services outsourcing agreement with HP Enterprise Services, LLC, and are continually expanding and improving our proprietary clinical, data management, and reporting systems to continue to meet the information management requirements of our services. The behavior change techniques and predictive modeling incorporated in our technology identify an individual’s readiness to change and provide personalized support through appropriate interactions using a range of methods desired by an individual, including venue-based face-to-face; print; phone; mobile and remote devices; on-line; emerging modalities; and any combination thereof to motivate and sustain healthy behaviors.

#### Business Strategy

The World Health Organization defines health as “...not only the absence of infirmity and disease, but also a state of physical, mental, and social well-being.”

Our business strategy reflects our passion to enhance health and well-being and, as a result, reduce



overall healthcare costs and improve workforce engagement, yielding better business performance for our customers. Our solutions are designed to improve well-being by helping people to:

- adopt or maintain healthy behaviors;
- reduce health-related risk factors; and
- optimize care for identified health conditions.

Through our solutions, we work to optimize the health and well-being of entire populations, one person at a time, domestically and internationally, thereby creating value by reducing overall healthcare costs and improving productivity and performance for individuals, families, health plans, governments, employers, integrated healthcare systems and communities.

We believe it is critical to impact an entire population's underlying health status and well-being in a long-term, cost effective way. Believing that what gets measured gets acted upon, in 2008, we entered into an exclusive, 25-year relationship with Gallup to create a definitive measure and empiric database of changes in the well-being of the U.S. population, known as the Gallup-Healthways Well-Being Index® ("WBI"), as well as processes to establish benchmarking for purposes of comparing the well-being of any subset of the national population. The responses to the nearly 1.8 million completed WBI surveys to date have provided Gallup and us with an unmatched database to support our mutual goal of understanding the causes and effects of well-being for a population. This relationship was expanded in 2011 with the launch of the Gallup-Healthways Well-Being Index in the United Kingdom and Germany, indicating a growing global interest in gaining clear insights for government and business leaders charged with shaping the policy responses necessary to improve health, increase individual and organizational performance, lower healthcare costs and achieve sustained economic growth. In October 2012 we created a global joint venture with Gallup that will develop the next generation of Gallup-Healthways individual well-being assessment tools to provide employers, health providers, insurers and other interested parties with validated tools to assess, measure and report on changes in the well-being of their employees, patients, members and customers. Under the joint venture agreement, we will acquire an increasing equity interest in the joint venture over a five-year period beginning in January 2013. We have contractual cash obligations of \$6.5 million per year for the first three years of the agreement and between \$5.0 million and \$8.0 million for each of the final two years of the agreement (such amounts to be determined during the fourth quarter of 2015).

To enhance health and well-being within their respective populations, our current and prospective customers require solutions that focus on the underlying drivers of healthcare demand, address worsening health status, reverse or slow unsustainable cost trends, foster healthy behaviors, mitigate health risk factors, and manage chronic conditions. Our strategy is to deliver programs that engage individuals and help them enhance their health status and well-being regardless of their starting point. We believe we can achieve health and well-being improvements in a population and generate significant cost savings and increases in productivity by providing effective programs that support the individual throughout his or her well-being journey.

We are adding and enhancing solutions to extend our reach and effectiveness and to meet increasing demand for integrated solutions. The flexibility of our programs allows customers to provide a range of services they deem appropriate for their organizations. Customers may select from certain single program options up to a total-population approach, in which all members of a customer's population are eligible to receive our services. Recently signed contracts have expanded both the level of integration and breadth of services provided to major health plans as they develop and implement a number of patient-centered medical home models. Our services extend beyond chronic care and wellness programs to include care management and pharmacy benefit management, as well as health promotion, prevention and quality improvement solutions.

Our strategy includes, as a priority, the ongoing expansion of our value proposition through our total population management solution. This solution, in addition to improving individuals' health and reducing direct





healthcare costs, targets a much larger improvement in employer profitability by reducing the impact of lost productivity for health-related reasons. With the success of our total population management solution, we expect to gain an even greater competitive advantage in responding to employers' needs for a healthier, higher-performing and less costly workforce.

Our strategy also includes the further enhancement and deployment of our proprietary next generation technology platform known as Embrace™. This platform, which is essential to our total population management solution, enables us to integrate data from the healthcare organizations and other entities interacting with an individual. Embrace provides for the delivery of our integrated solutions and ongoing communications between the individual and his or her medical and health experts, using a range of methods, including venue-based face-to-face; print; phone; mobile and remote devices; on-line; emerging modalities; and any combination thereof.

Significant changes in government regulation of healthcare continue to afford us expanding opportunities to provide services to integrated healthcare systems, hospitals, and physicians in addition to health plans and employers. In 2011 we acquired Navvis & Company, a well-established provider of strategic counsel and change management services enabling its healthcare system clients to become future-ready clinical enterprises within healthcare's rapidly emerging value-based reimbursement system. Our strategy includes providing integrated healthcare systems, hospitals, and physician enterprises both consultative strategic planning services and a range of capabilities that enable and support the delivery of Physician-Directed Population Health solutions.

We plan to increase our competitive advantage in delivering our services by leveraging the scope of our capabilities, including our medical information content, behavior change processes and techniques, strategic relationships, health provider networks, and fitness center relationships. We also plan to continue to scale the delivery of our solutions employing a blend of our scalable, state-of-the-art well-being improvement centers and proprietary technologies, modalities, and techniques. We may add new capabilities and technologies through internal development, strategic alliances with other entities, and/or selective acquisitions or investments. Examples include our collaboration with Blue Zones, LLC in delivering a scaled well-being improvement solution to support the Healthiest State initiative in Iowa; our investment in our wholly-owned subsidiary MeYou Health, LLC in bringing to market well-being improvement tools in the social media space through web and personal device delivery methods; and our recently expanded strategic relationship with Johns Hopkins Medicine to commercialize the sustained weight loss program Innergy resulting from a three-year clinical trial conducted by the National Heart, Lung and Blood Institute.

We anticipate continuing to enhance, expand and integrate additional capabilities with health plans and integrated healthcare systems and to pursue opportunities with employers, domestic government entities, and communities, as well as the public and private sectors of healthcare in international markets.

#### Critical Accounting Policies

We describe our accounting policies in Note 1 of the Notes to the Consolidated Financial Statements in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011. We prepare the consolidated financial statements in conformity with U.S. GAAP, which requires us to make estimates and judgments that affect the reported amounts of assets and liabilities and related disclosures at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results may differ from those estimates.

We believe the following accounting policies are the most critical in understanding the estimates and judgments that are involved in preparing our financial statements and the uncertainties that could impact our consolidated results of operations, financial condition and cash flows.



## Revenue Recognition

Our fees are generally billed on a per member per month (“PMPM”) basis or upon member participation. For PMPM fees, we generally determine our contract fees by multiplying the contractually negotiated PMPM rate by the number of members covered by our services during the month. We typically set PMPM rates during contract negotiations with customers based on the value we expect our programs to create and a sharing of that value between the customer and the Company. In addition, some of our services, such as the Healthways SilverSneakers fitness solution, include fees that are based upon member participation.

Our contracts with health plans generally range from three to five years with provisions for subsequent renewal; contracts with self-insured employers typically have one to three-year terms. Some of our contracts allow the customer to terminate early.

Some of our contracts place a portion of our fees at risk based on achieving certain performance metrics, cost savings, and/or clinical outcomes improvements (“performance-based”). Approximately 7% of revenues recorded during the nine months ended September 30, 2012 were performance-based and were subject to final reconciliation as of September 30, 2012.

We recognize revenue as follows: 1) we recognize the fixed portion of PMPM fees and fees for service as revenue during the period we perform our services; and 2) we recognize performance-based revenue based on the most recent assessment of our performance, which represents the amount that the customer would legally be obligated to pay if the contract were terminated as of the latest balance sheet date.

We generally bill our customers each month for the entire amount of the fees contractually due for the prior month’s enrollment, which typically includes the amount, if any, that is performance-based and may be subject to refund should we not meet performance targets. Fees for service are typically billed in the month after the services are provided. Deferred revenues arise from contracts that permit upfront billing and collection of fees covering the entire contractual service period, generally 12 months. A limited number of our contracts provide for certain performance-based fees that cannot be billed until after they are reconciled with the customer.

We generally assess our level of performance for our contracts based on medical claims and other data that the customer is contractually required to supply. A minimum of four to nine months’ data is typically required for us to measure performance. In assessing our performance, we may include estimates such as medical claims incurred but not reported and a medical cost trend compared to a baseline year. In addition, we may also provide contractual allowances for billing adjustments (such as data reconciliation differences) as appropriate.

If data is insufficient or incomplete to measure performance, or interim performance measures indicate that we are not meeting performance targets, we do not recognize performance-based fees subject to refund as revenues but instead record them in a current liability account entitled “contract billings in excess of earned revenue.” Only in the event we do not meet performance levels by the end of the measurement period, typically one year, are we contractually obligated to refund some or all of the performance-based fees. We would only reverse revenues that we had already recognized if performance to date in the measurement period, previously above targeted levels, subsequently dropped below targeted levels. Historically, any such adjustments have been immaterial to our financial condition and results of operations.

During the settlement process under a contract, which generally occurs six to eight months after the end of a contract year, we settle any performance-based fees and reconcile healthcare claims and clinical data. As of



September 30, 2012, cumulative performance-based revenues that have not yet been settled with our customers but that have been recognized in the current and prior years totaled approximately \$56.2 million, all of which were based on actual data received from our customers. Data reconciliation differences, for which we provide contractual allowances until we reach agreement with respect to identified issues, can arise between the customer and us due to customer data deficiencies, omissions, and/or data discrepancies.

Performance-related adjustments (including any amounts recorded as revenue that were ultimately refunded), changes in estimates, or data reconciliation differences may cause us to recognize or reverse revenue in a current fiscal year that pertains to services provided during a prior fiscal year. During the nine months ended September 30, 2012, we recognized a net increase in revenue of \$8.0 million that related to services provided prior to 2012.

#### Impairment of Intangible Assets and Goodwill

We review goodwill for impairment at the reporting unit level (operating segment or one level below an operating segment) on an annual basis or more frequently whenever events or circumstances indicate that the carrying value may not be recoverable. We may elect to perform a qualitative assessment to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying value. If we conclude during the qualitative assessment that this is the case, we perform a quantitative review as described below. Otherwise, we do not perform a quantitative review. If we elect not to perform a qualitative assessment, then we proceed to the quantitative review described below.

During a quantitative review of goodwill, we estimate the fair value of each reporting unit using a combination of a discounted cash flow model and a market-based approach, and we reconcile the aggregate fair value of our reporting units to our consolidated market capitalization. Estimating fair value requires significant judgments, including management's estimate of future cash flows, which is dependent on internal forecasts, estimation of the long-term growth rate for our business, the useful life over which cash flows will occur, and determination of our weighted average cost of capital, as well as relevant comparable company earnings multiples for the market-based approach. Changes in these estimates and assumptions could materially affect the estimate of fair value and potential goodwill impairment for each reporting unit.

If we determine that the carrying value of goodwill is impaired based upon an impairment review, we calculate any impairment using a fair-value-based goodwill impairment test as required by U.S. GAAP. The fair value of a reporting unit is the price that would be received to sell the unit as a whole in an orderly transaction between market participants at the measurement date.

Except for a certain trade name that has an indefinite life and is not subject to amortization, we amortize identifiable intangible assets, such as acquired technologies and customer contracts, using the straight-line method over their estimated useful lives. We assess the potential impairment of intangible assets subject to amortization whenever events or changes in circumstances indicate that the carrying values may not be recoverable. If we determine that the carrying value of other identifiable intangible assets may not be recoverable, we calculate any impairment using an estimate of the asset's fair value based on the estimated price that would be received to sell the asset in an orderly transaction between market participants.

We review intangible assets not subject to amortization, which consist of a certain trade name, on an annual basis or more frequently whenever events or circumstances indicate that the assets might be impaired. We estimate the fair value of the trade name using a present value technique, which requires management's estimate of future revenues attributable to this trade name, estimation of the long-term growth rate for these revenues, and determination of our weighted average cost of capital. Changes in these estimates and assumptions could materially affect the estimate of fair value for the trade name.



Future events could cause us to conclude that impairment indicators exist and that goodwill and/or other intangible assets are impaired. Any resulting impairment loss could have a material adverse impact on our financial condition and results of operations.

#### Income Taxes

The objectives of accounting for income taxes are to recognize the amount of taxes payable or refundable for the current year and deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an entity's financial statements or tax returns. Accounting for income taxes requires significant judgment in determining income tax provisions, including determination of deferred tax assets, deferred tax liabilities, and any valuation allowances that might be required against deferred tax assets, and in evaluating tax positions.

We recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position should be measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement. U.S. GAAP also provides guidance on derecognition of income tax assets and liabilities, classification of current and deferred income tax assets and liabilities, accounting for interest and penalties associated with tax positions, and income tax disclosures. Judgment is required in assessing the future tax consequences of events that have been recognized in our financial statements or tax returns. Variations in the actual outcome of these future tax consequences could materially impact our consolidated financial position, results of operations, or cash flows.

#### Share-Based Compensation

We measure and recognize compensation expense for all share-based payment awards based on estimated fair values at the date of grant. Determining the fair value of stock options at the grant date requires judgment in developing assumptions, which involve a number of variables. These variables include, but are not limited to, the expected stock price volatility over the term of the awards and expected stock option exercise behavior. In addition, we also use judgment in estimating the number of share-based awards that are expected to be forfeited.



## Results of Operations

The following table shows the components of the consolidated statements of comprehensive income for the three and nine months ended September 30, 2012 and 2011 expressed as a percentage of revenues.

|  | Three Months Ended<br>September 30, |        | Nine Months Ended<br>September 30, |        |
|--|-------------------------------------|--------|------------------------------------|--------|
|  | 2012                                | 2011   | 2012                               | 2011   |
| Revenues   | 100.0%                              | 100.0% | 100.0%                             | 100.0% |
| Cost of services (exclusive of depreciation and amortization included below) | 76.1 %                              | 73.5 % | 78.9%                              | 74.2%  |
| Selling, general and administrative expenses                                 | 8.8 %                               | 8.1 %  | 8.7%                               | 9.8 %  |
| Depreciation and amortization  | 8.0 %                               | 7.1 %  | 7.6%                               | 7.3%   |
| Operating income   | 7.1 %                               | 11.3 % | 4.8%                               | 8.7%   |
| Interest expense   | 2.0 %                               | 1.8 %  | 2.2%                               | 1.9%   |
| Income before income taxes   | 5.1 %                               | 9.5 %  | 2.6%                               | 6.8%   |
| Income tax expense   | 2.1 %                               | 4.1 %  | 1.1%                               | 2.9%   |
| Net income (1)   | 3.0 %                               | 5.4 %  | 1.5%                               | 3.8%   |

(1) Figures may not add due to rounding.

## Revenues

Revenues decreased \$9.6 million and \$6.8 million, or 5.5% and 1.3%, for the three and nine months ended September 30, 2012 compared to the same periods in 2011, primarily due to decreases in revenue from the wind-down of our contract with CIGNA in advance of the contract's expiration in February 2013, as well as certain other contract or program terminations with three smaller health plan customers. These decreases were somewhat offset by the following:

- an increase in participation in our fitness solutions, as well as in the number of members eligible to participate in such programs;
  - the commencement of contracts with new customers; and
- an increase in performance-based revenues due to our ability to measure and achieve performance targets on certain contracts during the three and nine months ended September 30, 2012.

## Cost of Services

Cost of services (excluding depreciation and amortization) as a percentage of revenues increased to 76.1% and 78.9% for the three and nine months ended September 30, 2012, respectively, compared to 73.5% and 74.2% for the three and nine months ended September 30, 2011, respectively, primarily due to the following:

- the wind-down of our contract with CIGNA and certain other contract or program terminations with three smaller health plan customers to whom we provided traditional disease management services, all of which carried a lower than average cost of services as a percentage of revenues;
  - increased costs related to the launch of new business in the evolving health systems market; and
- an expanded and extended contract during the three and nine months ended September 30, 2012 which moved from a cost-plus model to a volume-based model in which revenues are expected to ramp over time, while the underlying cost structure remained consistent with the three and nine months ended September 30, 2011.

These increases were partially offset by decreases in cost of services (excluding depreciation and amortization) as a percentage of revenues due to the following:

- an increase in performance-based revenues wherein a significant portion of the related costs were incurred and recognized in a prior period;
- costs associated with implementing a new and innovative contract in 2011 for which we weren't able to recognize revenue until 2012;
- decreased costs associated with an initiative during the three months ended September 30, 2011 to promote member participation in certain of our programs; and
  - efficiencies gained in our fitness solutions through certain cost management initiatives.

#### Selling, General and Administrative Expenses

Selling, general and administrative expenses as a percentage of revenues increased to 8.8% for the three months ended September 30, 2012 compared to 8.1% for the three months ended September 30, 2011 primarily due to increased legal fees related to new and ongoing legal proceedings.

Selling, general and administrative expenses as a percentage of revenues decreased to 8.7% for the nine months ended September 30, 2012 compared to 9.8% for the nine months ended September 30, 2011 primarily due to a restructuring of the Company that was largely completed during the fourth quarter of 2011.

#### Depreciation and Amortization

Depreciation and amortization expense increased \$0.8 million and \$0.9 million for the three and nine months ended September 30, 2012 compared to the same periods in 2011, primarily due to increased depreciation expense related to our Embrace platform.

#### Interest Expense

Interest expense remained relatively consistent for the three months ended September 30, 2012 compared to the three months ended September 30, 2011. For the nine months ended September 30, 2012, interest expense increased \$1.0 million compared to the same period in 2011, primarily due to the write-off of previously deferred loan costs as a result of entering into the Fifth Amended Credit Agreement on June 8, 2012.

#### Income Tax Expense

Our effective tax rate decreased to 41.1% for the three months ended September 30, 2012 compared to 43.5% for the three months ended September 30, 2011, primarily due to a favorable impact on the effective tax rate related to routine reconciliations of tax return filings as well as a favorable impact from the higher relative level of foreign earnings, which are taxed at statutory rates lower than our domestic earnings.



Our effective tax rate remained relatively consistent for the nine months ended September 30, 2012 compared to the nine months ended September 30, 2011.

#### Outlook

We anticipate that revenues for 2012 will decrease slightly compared to 2011 primarily due to the wind-down of our current contract with CIGNA in advance of the contract's expiration in February 2013 and the expansion and extension of a certain contract during the three months ended September 30, 2012 which moved from a cost-plus model to a volume-based model in which revenues are expected to ramp over time. We expect these decreases will be mostly offset by increased revenues from new and expanded contracts and an increase in participation in our fitness solutions, as well as in the number of members eligible to participate in such solutions.

We expect cost of services (excluding depreciation and amortization) as a percentage of revenues for 2012 to increase compared to 2011 primarily due to the wind-down of our current contract with CIGNA and certain contract or program terminations with three smaller health plan customers to whom we provided traditional disease management services, all of which carried a lower than average cost of services as a percentage of revenues. We expect selling, general and administrative expenses as a percentage of revenues for 2012 to decrease slightly compared to 2011 primarily due to cost savings from a restructuring of the Company that was largely completed during the fourth quarter of 2011. We anticipate depreciation and amortization expense for 2012 will increase compared to 2011 primarily due to continued investment in our Embrace platform.

As discussed in "Liquidity and Capital Resources" below, a significant portion of our long-term debt is subject to fixed interest rate swap agreements; however, we cannot predict the potential for changes in interest rates, which would impact our variable rate debt.

#### Liquidity and Capital Resources

Operating activities for the nine months ended September 30, 2012 provided cash of \$23.4 million compared to \$58.3 million for the nine months ended September 30, 2011, primarily due to the following:

- a decrease in net income;
- an increase in days sales outstanding from 50 days at September 30, 2011 to 57 days at September 30, 2012;
  - an increase in certain long-term incentive and other benefit payments; and
- an increase in severance payments in 2012 made as a result of a restructuring of the Company that was largely completed during the fourth quarter of 2011.

Investing activities during the nine months ended September 30, 2012 used \$51.5 million in cash, which primarily consisted of capital expenditures associated with our Embrace platform.

Financing activities during the nine months ended September 30, 2012 provided \$29.8 million in cash, primarily due to net borrowings under our credit agreement.

On June 8, 2012, we entered into the Fifth Amended Credit Agreement. The Fifth Amended Credit Agreement provides us with a \$200.0 million revolving credit facility that expires June 8, 2017 and includes a swingline sub facility of \$20.0 million and a \$75.0 million sub facility for letters of credit. The Fifth Amended Credit Agreement also provides a \$200.0 million term loan facility that matures on June 8, 2017, all of which remained outstanding on September 30, 2012, and an uncommitted incremental accordion facility of \$200.0



million. As of September 30, 2012, availability under the revolving credit facility totaled \$71.9 million as calculated under the most restrictive covenant.

Borrowings under the Fifth Amended Credit Agreement generally bear interest at variable rates based on a margin or spread in excess of either (1) the one-month, two-month, three-month or six-month rate (or with the approval of affected lenders, nine-month or twelve-month rate) for Eurodollar deposits (“LIBOR”) or (2) the greatest of (a) the prime lending rate, (b) the federal funds rate plus 0.50%, and (c) one-month LIBOR plus 1.00% (the “Base Rate”), as selected by the Company. The LIBOR margin varies between 1.75% and 3.00%, and the Base Rate margin varies between 0.75% and 2.00%. The Fifth Amended Credit Agreement also provides for an annual fee ranging between 0.30% and 0.50% of the unused commitments under the revolving credit facility. The Fifth Amended Credit Agreement is secured by guarantees from all of the Company’s active domestic subsidiaries and by security interests in substantially all of the Company’s and such subsidiaries’ assets.

We are required to repay outstanding revolving loans under the revolving credit facility on June 8, 2017. We are required to repay term loans in quarterly principal installments aggregating (1) 1.250% of the original aggregate principal amount of the term loans during each of the first eight quarters following the closing, (2) 1.875% of the original aggregate principal amount of the term loans during each of the next four quarters following the closing, (3) 2.500% of the original aggregate principal amount of the term loans during each of the remaining quarters prior to maturity on June 8, 2017, at which time the entire unpaid principal balance of the term loans is due and payable.

The Fifth Amended Credit Agreement contains various financial covenants, which require us to maintain, as defined therein, ratios or levels of 1) total funded debt to EBITDA and 2) fixed charge coverage. The Fifth Amended Credit Agreement also limits the amount of dividends and repurchases of the Company’s common stock. As of September 30, 2012, we were in compliance with all of the covenant requirements of the Fifth Amended Credit Agreement.

In order to reduce our exposure to interest rate fluctuations on our floating rate debt commitments, we maintain interest rate swap agreements that effectively modify our exposure to interest rate risk by converting a portion of our floating rate debt to fixed obligations, thus reducing the impact of interest rate changes on future interest expense. Under these agreements, we receive a variable rate of interest based on LIBOR, and we pay a fixed rate of interest with interest rates ranging from 0.370% to 3.385% plus a spread. We maintain interest rate swap agreements with current notional amounts of \$475.0 million and termination dates ranging from December 31, 2012 to December 31, 2016. Of this amount, \$200.0 million will become effective in 2013, and \$50.0 million in 2015, as older interest rate swap agreements expire. We have designated these interest rate swap agreements as qualifying cash flow hedges. We currently meet the hedge accounting criteria under U.S. GAAP in accounting for these interest rate swap agreements.

In October 2010, our Board of Directors authorized a share repurchase program, which allowed for the repurchase of up to \$60 million of our common stock from time to time in the open market or in privately negotiated transactions through October 19, 2012. As of September 30, 2012, \$31.8 million of our common stock was still subject to repurchase under this program. No shares were repurchased between October 1 and October 19, 2012 pursuant to the program.

We believe that cash flows from operating activities, our available cash, and our anticipated available credit under the Fifth Amended Credit Agreement will continue to enable us to meet our contractual obligations and to fund our current operations for the foreseeable future. However, if our operations require significant additional financing resources, such as capital expenditures for technology improvements, additional well-being improvement centers and/or letters of credit or other forms of financial assurance to guarantee our performance under the terms of new contracts, or if we are required to refund performance-based fees pursuant to contract terms, we may need to raise additional capital by expanding our existing credit facility and/or issuing debt or



equity. If we face a limited ability to arrange such financing, it may restrict our ability to effectively operate our business. We cannot assure you that we would always be able to secure additional financing if needed and, if such funds were available, whether the terms or conditions would be acceptable to us.

If contract development accelerates or acquisition opportunities arise, we may need to issue additional debt or equity to provide the funding for these increased growth opportunities. We may also issue equity in connection with future acquisitions or strategic alliances. We cannot assure you that we would be able to issue additional debt or equity on terms that would be acceptable to us.

#### Recently Issued Accounting Standard

In July 2012, the FASB issued ASU No. 2012-02, “Intangibles—Goodwill and Other (Topic 350)—Testing Indefinite-Lived Intangible Assets for Impairment”. ASU No. 2012-02 permits an entity to perform a qualitative assessment to determine whether it is more likely than not that the fair value of an indefinite-lived intangible asset is less than its carrying value. If the entity concludes that this is the case, it must perform the currently prescribed quantitative impairment test by comparing the fair value of the indefinite-lived intangible asset with its carrying value. Otherwise, the quantitative impairment test is not required. ASU No. 2012-02 is effective for fiscal years beginning after September 15, 2012, with earlier adoption permitted. We do not expect the adoption of this standard to have a material impact on our consolidated results of operations, financial position, cash flows, or notes to the consolidated financial statements.

#### Item 3. Quantitative and Qualitative Disclosures About Market Risk

We are subject to market risk related to interest rate changes, primarily as a result of the Fifth Amended Credit Agreement. Borrowings under the Fifth Amended Credit Agreement generally bear interest at variable rates based on a margin or spread in excess of either (1) the one-month, two-month, three-month or six-month rate (or with the approval of affected lenders, nine-month or twelve-month rate) for Eurodollar deposits (“LIBOR”) or (2) the greatest of (a) the prime lending rate, (b) the federal funds rate plus 0.50%, and (c) one-month LIBOR plus 1.00% (the “Base Rate”), as selected by the Company. The LIBOR margin varies between 1.75% and 3.00%, and the Base Rate margin varies between 0.75% and 2.00%.

In order to manage our interest rate exposure under the Fifth Amended Credit Agreement, we have entered into interest rate swap agreements effectively converting a portion of our floating rate debt to fixed obligations with interest rates ranging from 0.370% to 3.385% plus a spread.



A one-point interest rate change would have resulted in a change in interest expense of approximately \$0.8 million for the nine months ended September 30, 2012.

As a result of our investment in international initiatives, we are also exposed to foreign currency exchange rate risks. Because a significant portion of these risks is economically hedged with currency options and forwards contracts and because our international initiatives are not yet material to our consolidated results of operations, a 10% change in foreign currency exchange rates would not have had a material impact on our consolidated results of operations, financial position, or cash flows for the nine months ended September 30, 2012. We do not execute transactions or hold derivative financial instruments for trading purposes.

#### Item 4. Controls and Procedures

##### Evaluation of Disclosure Controls and Procedures

Our chief executive officer and chief financial officer have reviewed and evaluated the effectiveness of our “disclosure controls and procedures” (as defined in Rule 13a-15(e) and 15d-15(e) promulgated under the Securities Exchange Act of 1934, as amended (the “Exchange Act”)) as of September 30, 2012. Based on that evaluation, the chief executive officer and chief financial officer have concluded that our disclosure controls and procedures are effective. They are designed to ensure that information required to be disclosed in the reports that the Company files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the U.S. Securities and Exchange Commission’s rules and forms and to ensure that information required to be disclosed in the reports that the Company files or submits under the Exchange Act is accumulated and communicated to management, including our chief executive officer and chief financial officer, to allow timely decisions regarding required disclosure.

##### Changes in Internal Control over Financial Reporting

There have been no changes in our internal controls over financial reporting during the three months ended September 30, 2012 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## Part II

### Item 1. Legal Proceedings

#### Contract Dispute

We currently are involved in a contractual dispute with Blue Cross Blue Shield of Minnesota regarding fees paid to us as part of a former contractual relationship. On January 25, 2010, Blue Cross Blue Shield of Minnesota issued notice of arbitration with the American Arbitration Association in Minneapolis alleging a violation of certain contract provisions. We believe we performed our services in compliance with the terms of our agreement and that the assertions made in the arbitration notice are without merit. On August 3, 2011, we asserted numerous counterclaims against Blue Cross Blue Shield of Minnesota. We are not able to reasonably estimate a range of potential losses, if any.

#### Anti-Trust Lawsuit

On May 1, 2012, American Specialty Health Group (“ASH”) amended a claim (the “Amended Claim”) that it had previously filed against the Company in the U.S. District Court in the Southern District of California (“Court”) on December 2, 2011 (the “Original Claim”). The Original Claim alleged that the Company’s exclusivity provisions in some of its contracts with participating locations in its SilverSneakers fitness network violate California’s Unfair Competition Law (“UCL”) and that the Company interfered with ASH’s contractual relations and prospective economic advantages. The Amended Claim added allegations that the Company is in violation of the Sherman Antitrust Act (the “Act”) because such exclusivity provisions create illegal restraints on trade and constitute monopolization or attempted monopolization in violation of the Act. Under the Amended Claim, ASH is seeking damages in excess of \$15,000,000, treble damages under the Act, and injunctive relief. The Company has asserted counterclaims against ASH for interference and violation of the UCL, and on October 12, 2012, the Court granted the Company’s motion to add an additional counterclaim that ASH has falsely advertised the composition of its fitness facility network in violation of the Lanham Act.

We believe ASH’s claims are without merit and intend to vigorously defend ourselves against the Amended Claim.

#### Performance Award Lawsuit

On September 4, 2012, Milton Pfeiffer (“Plaintiff”), claiming to be a stockholder of the Company, filed a putative derivative action against the Company and the Board of Directors in Delaware Chancery Court alleging that the Compensation Committee and the Board of Directors breached their fiduciary duties and violated the Company’s 2007 Stock Incentive Plan (the “Plan”) by granting Ben R. Leedle, Jr., Chief Executive Officer and President of the Company, a discretionary performance award under the Plan of 500,000 shares (the “Performance Award”), which consisted of 365,000 performance awards issued in November 2011 and 135,000 performance awards issued in February 2012. Plaintiff alleges that the Performance Award exceeded what is authorized by the Plan and that the Company’s 2012 proxy statement, in which the Performance Award is disclosed, is false and misleading. Plaintiff also alleges that Mr. Leedle breached his fiduciary duties and was unjustly enriched by receiving the Performance Award. Plaintiff is seeking, inter alia, the rescission or disgorgement of all alleged “excess” awards granted to Mr. Leedle under the Performance Award, to recover any incidental damages to the Company, and an award of attorneys’ fees and expenses. We believe Plaintiff’s claims are without merit and intend to vigorously defend ourselves against the action.



## Outlook

We are also subject to other contractual disputes, claims and legal proceedings that arise from time to time in the ordinary course of our business. While we are unable to estimate a range of potential losses, we do not believe that any of the legal proceedings pending against us as of the date of this report will have a material adverse effect on our liquidity or financial condition. As these matters are subject to inherent uncertainties, our view of these matters may change in the future.

### Item 1A. Risk Factors

In addition to the other information set forth in this report, you should carefully consider the risks and uncertainties previously reported under the caption “Part I — Item 1A. Risk Factors” in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011, the occurrence of which could materially and adversely affect our business, prospects, financial condition and operating results. The risks previously reported and described in the Annual Report on Form 10-K for the fiscal year ended December 31, 2011 and in this report are not the only risks facing our business. Additional risks and uncertainties not currently known to us or those we currently deem to be immaterial may also materially and adversely affect our business operations.

There have been no material changes to our risk factors previously disclosed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011.

### Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

The Company’s Board of Directors authorized a share repurchase program, which was publicly announced on October 21, 2010. The share repurchase program allows for the repurchase of up to \$60 million of our common stock from time to time in the open market or in privately negotiated transactions through October 19, 2012. No shares were repurchased between July 1, 2012 and September 30, 2012 pursuant to the program.

| Period                       | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs |
|------------------------------|----------------------------------|------------------------------|--|--|
| July 1 through 31, 2012      | —                                | —                            | 2,254,953  | \$31,813,383   |
| August 1 through 31, 2012    | —                                | —                            | 2,254,953  | \$31,813,383   |
| September 1 through 30, 2012 | —                                | —                            | 2,254,953  | \$31,813,383   |
| Total                        | —                                |                              |  |  |

### Item 3. Defaults Upon Senior Securities

Not Applicable.

Item 4. Mine Safety  
Disclosures

Not Applicable.

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Item 5. Other  
Information

Not Applicable.

Item 6. Exhibits

(a) Exhibits

31.1 Certification of Chief Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended

31.2 Certification of Chief Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended

32 Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

101.INS XBRL Instance Document

101.SCH XBRL Taxonomy Extension Schema

101.CAL XBRL Taxonomy Extension Calculation Linkbase

101.DEF XBRL Taxonomy Extension Definition Linkbase

101.LAB XBRL Taxonomy Extension Label Linkbase

101.PRE XBRL Taxonomy Extension Presentation Linkbase

SIGNATURES

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 hereunto duly authorized.

Healthways, Inc.  
(Registrant)

Date November 8, 2012

By /s/ Alfred Lumsdaine  
Alfred Lumsdaine  
Chief Financial Officer  
(Principal Financial Officer)

