HEALTHWAYS, INC
Form 10-Q
January 09, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended November 30, 2006

or

o Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the transition period from _____ to _____

Commission File Number 000-19364

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

Delaware	62-1117144
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)

3841 Green Hills Village Drive, Nashville, TN 37215
(Address of Principal Executive Offices) (Zip Code)

615-665-1122
(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 x No o

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

Large accelerated filer x Accelerated filer o Non-accelerated filer o

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

Yes o No x

As of January 4, 2007 there were outstanding 34,921,291 shares of the Registrant s Common Stock, par value $.001 per share.

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Part I

Item 1. Financial Statements

HEALTHWAYS, INC.

CONSOLIDATED BALANCE SHEETS

(In thousands)

(Unaudited)

ASSETS

	November 30, 2006	August 31, 2006
Current assets:		
Cash and cash equivalents	$ 161,902	$ 154,792
Accounts receivable, net	60,419	52,978
Prepaid expenses and other current assets	10,799	9,397
Deferred tax asset	4,292	3,726
Total current assets	237,412	220,893
Property and equipment:		
Leasehold improvements	17,191	16,009
Computer equipment and related software	77,679	75,524
Furniture and office equipment	19,071	18,542
	113,941	110,075
Less accumulated depreciation	(69,367)	(63,525)
	44,574	46,550
Long-term deferred tax asset	4,452	2,557
Other assets	3,019	4,052
Intangible assets, net	11,222	12,199
Goodwill, net	96,252	96,135
Total assets	$ 396,931	$ 382,386

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

	November 30, 2006	August 31, 2006
Current liabilities:		
Accounts payable	$ 12,209	$ 9,221
Accrued salaries and benefits	14,916	36,007
Accrued liabilities	7,234	5,748
Contract billings in excess of earned revenue	44,377	35,013
Income taxes payable	10,495	7,906
Current portion of long-term debt	185	180
Current portion of long-term liabilities	2,471	2,349
Total current liabilities	91,887	96,424
Long-term debt	188	236
Other long-term liabilities	11,267	10,853
Stockholders equity:		
Preferred stock $.001 par value, 5,000,000 shares authorized, none outstanding		
Common stock $.001 par value, 75,000,000 shares authorized, 34,719,875 and 34,597,748 shares outstanding	35	35
Additional paid-in capital	147,098	140,216
Retained earnings	146,456	134,622
Total stockholders equity	293,589	274,873
Total liabilities and stockholders equity	$ 396,931	$ 382,386

See accompanying notes to the consolidated financial statements.

HEALTHWAYS, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except earnings per share data)

(Unaudited)

	Three Months Ended November 30,	
	2006	**2005**
Revenues	$ 117,055	$ 90,592
Cost of services (exclusive of depreciation and amortization shown below)	77,549	63,845
Selling, general and administrative expenses	12,584	10,123
Depreciation and amortization	6,818	5,663
Operating income	20,104	10,961
Interest expense	295	255
Income before income taxes	19,809	10,706
Income tax expense	7,975	4,250
Net income	$ 11,834	$ 6,456
Earnings per share:		
Basic	$ 0.34	$ 0.19
Diluted	$ 0.32	$ 0.18
Weighted average common shares and equivalents:		
Basic	34,627	33,961
Diluted	36,608	35,973

See accompanying notes to the consolidated financial statements.

HEALTHWAYS, INC.

CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS EQUITY

For the Three Months Ended November 30, 2006

(In thousands)

(Unaudited)

	Preferred Stock	Common Stock	Additional Paid-in Capital	Retained Earnings	Total
Balance, August 31, 2006	$	$ 35	$ 140,216	$ 134,622	$ 274,873
Net income				11,834	11,834
Exercise of stock options and other			1,435		1,435
Tax benefit of option exercises			1,403		1,403
Share-based employee compensation expense			4,044		4,044
Balance, November 30, 2006	$	$ 35	$ 147,098	$ 146,456	$ 293,589

See accompanying notes to the consolidated financial statements.

HEALTHWAYS, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	Three Months Ended November 30, 2006	Three Months Ended November 30, 2005
Cash flows from operating activities:		
Net income	$ 11,834	$ 6,456
Adjustments to reconcile net income to net cash provided by operating activities, net of business acquisitions:		
Depreciation and amortization	6,818	5,663
Amortization of deferred loan costs	120	117
Share-based employee compensation expense	4,044	3,221
Excess tax benefits from share-based payment arrangements	(1,240)	(3,842)
Increase in accounts receivable, net	(7,441)	(9,886)
Increase in other current assets	(500)	(1,167)
Increase in accounts payable	2,988	1,058
Decrease in accrued salaries and benefits	(21,091)	(10,371)
Increase in other current liabilities	14,007	15,167
Deferred income taxes	(2,461)	(2,822)
Other	520	741
Decrease in other assets	1,767	159
Net cash flows provided by operating activities	9,365	4,494
Cash flows from investing activities:		
Acquisition of property and equipment	(3,865)	(4,716)
Business acquisitions, net of cash acquired	(866)	(22)
Other, net	(13)	
Net cash flows used in investing activities	(4,744)	(4,738)
Cash flows from financing activities:		
Increase in restricted cash		(28)
Deferred loan costs	(105)	(569)
Excess tax benefits from share-based payment arrangements	1,240	3,842
Payments of long-term debt	(43)	(26)
Exercise of stock options	1,397	2,235
Net cash flows provided by financing activities	2,489	5,454
Net increase in cash and cash equivalents	7,110	5,210
Cash and cash equivalents, beginning of period	154,792	63,467
Cash and cash equivalents, end of period	$ 161,902	$ 68,677

See accompanying notes to the consolidated financial statements.

HEALTHWAYS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(1) Interim Financial Reporting

The accompanying consolidated financial statements of Healthways, Inc. and its wholly-owned subsidiaries for the three months ended November 30, 2006 and 2005 are unaudited. However, in our opinion, the financial statements 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 accounting principles generally accepted in the United States 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 August 31, 2006.

(2) Share-Based Compensation

We have several shareholder-approved stock incentive plans for employees and directors. We currently have three types of share-based awards outstanding under these plans: stock options, restricted stock, and restricted stock units. We believe that such awards align the interests of our employees and directors with those of our stockholders. We account for share-based compensation in accordance with SFAS No. 123(R), Share-Based Payment. For the three months ended November 30, 2006 and 2005, we recognized share-based compensation costs of $4.0 million and $3.2 million, respectively.

In October 2006, we granted annual equity awards, including stock options and restricted stock units, for fiscal 2006 performance. A summary of our stock options as of November 30, 2006 and changes during the three months then ended is presented below:

Options	Shares (000s)	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term	Aggregate Intrinsic Value ($000s)
Outstanding at September 1, 2006	5,836	$ 18.87		
Granted	312	42.84		
Exercised	(120)	11.81		
Forfeited or expired	(13)	22.89		
Outstanding at November 30, 2006	6,015	20.24	6.1	$ 155,615
Exercisable at November 30, 2006	3,507	11.18	5.5	$ 122,063

The weighted-average grant-date fair value of options granted during the three months ended November 30, 2006 was $21.29.

The following table shows a summary of our restricted stock and restricted stock units (nonvested shares) as of November 30, 2006 as well as activity during the three months then ended.

Nonvested Shares	Shares (000s)	Weighted-Average Grant-Date Fair Value
Nonvested at September 1, 2006	160	$ 43.82
Granted	167	43.04
Vested	(3)	38.11
Forfeited		
Nonvested at November 30, 2006	324	$ 43.44

(3) Goodwill

The change in the carrying amount of goodwill during the three months ended November 30, 2006 is shown below:

(In $000s)	
Balance, August 31, 2006	$ 96,135
Health IQ purchase price adjustment	117
Balance, November 30, 2006	$ 96,252

The Health IQ Diagnostics, LLC (Health IQ) purchase price adjustment primarily relates to an earn-out agreement under which we are obligated to pay the former stockholders of Health IQ additional purchase price equal to a percentage of revenues recognized from Health IQ s programs in each of the fiscal quarters during the three-year period ending August 31, 2008.

(4) Intangible Assets

Intangible assets subject to amortization at November 30, 2006 consist of the following:

	Gross Carrying Amount	Accumulated Amortization	Net
(In $000s)			
Acquired technology	$ 10,163	$ 6,606	$ 3,557
Customer contracts	9,179	5,978	3,201
Other	200	80	120
Total	$ 19,542	$ 12,664	$ 6,878

Acquired technology, customer contracts, and other intangible assets are being amortized on a straight-line basis over a five-year estimated useful life. Total amortization expense for the three months ended November 30, 2006 and 2005 was $1.0 million. Estimated amortization expense is $2.9 million for the remainder of fiscal 2007, $3.9 million for fiscal 2008 and $40,000, $10,000, and zero for the three fiscal years thereafter, respectively.

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Intangible assets not subject to amortization at November 30, 2006 and 2005 consist of a trade name of $4.3 million.

(5) Derivative Investments and Hedging Activities

SFAS No. 133, Accounting for Derivative Investments and Hedging Activities, as amended, establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. It requires companies to record all derivatives at estimated fair value as either assets or liabilities on the balance sheet and to recognize the unrealized gains and losses, the treatment of which depends on whether the derivative is designated as a hedging instrument.

As a result of our investment in international initiatives, we are exposed to foreign currency exchange rate risks. A significant portion of these risks is economically hedged with currency options and forwards contracts in order to minimize our exposure to fluctuations in foreign currency exchange rates. Principal currencies hedged include the Euro and British pound. These derivative instruments serve as economic hedges and do not qualify for hedge accounting treatment under SFAS No. 133. Accordingly, they require current period mark-to-market accounting, with any change in fair value being recorded each period in the statement of operations. We record the fair market value of our derivatives, based on information provided by reliable third parties, as other current assets and accrued liabilities. We routinely monitor our foreign currency exposures to maximize the overall effectiveness of our foreign currency hedge positions.

(6) Long-Term Debt

On September 19, 2005, we entered into a Second Amended and Restated Revolving Credit Loan Agreement (the Second Amended Credit Agreement). The Second Amended Credit Agreement provides us with a $250.0 million revolving credit facility, including a swingline sub facility of $10.0 million and a $75.0 million sub facility for letters of credit, together with an uncommitted incremental accordion facility of $50.0 million, and expires on September 19, 2010. As of November 30, 2006, our available line of credit totaled $249.1 million.

The Second Amended Credit Agreement requires us to repay the principal on any loans at the maturity date of September 19, 2010. Borrowings under the Second Amended Credit Agreement generally bear interest, at our option, at LIBOR plus a spread of 0.875% to 1.5%, which is dependent on the ratio of total funded debt to EBITDA, or at the prime rate. The Second Amended Credit Agreement also provides for a fee ranging between 0.175% and 0.3% of unused commitments. The Second Amended Credit Agreement is secured by guarantees from our active domestic subsidiaries and by security interests in substantially all of our and our subsidiaries assets.

The Second Amended Credit Agreement contains various financial covenants, which require us to maintain, as defined, ratios or levels of (i) total funded debt to EBITDA, (ii) fixed charge coverage, and (iii) net worth. It also restricts the payment of dividends and limits the amount of repurchases of the Company s common stock. As of November 30, 2006, we were in compliance with all of the covenant requirements of the Second Amended Credit Agreement.

As of November 30, 2006, there were letters of credit outstanding under the Second Amended Credit Agreement for $0.9 million primarily to secure our ability to pay claims under our workers compensation high-deductible policy.

(7) Commitments and Contingencies

Pursuant to an earn-out agreement executed in connection with the acquisition of certain assets of Health IQ in June 2005, we are obligated to pay the former stockholders of Health IQ additional purchase price equal to a percentage of revenues recognized from Health IQ s programs in each of the fiscal quarters during the three-year period ending August 31, 2008.

In June 1994, a former employee whom we dismissed in February 1994 filed a whistle blower action on behalf of the United States government. Subsequent to its review of this case, the federal government determined not to intervene in the litigation. The employee sued Healthways, Inc. and our wholly-owned subsidiary, American Healthways Services, Inc. (AHSI), as well as certain named and unnamed medical directors and one named client hospital, West Paces Medical Center (WPMC), and other unnamed client hospitals.

Healthways, Inc. has since been dismissed as a defendant; however, the case is still pending against AHSI before the United States District Court for the District of Columbia. In addition, WPMC has settled claims filed against it as part of a larger settlement agreement that WPMC s parent organization, HCA Inc., reached with the United States government.

The complaint alleges that AHSI, the client hospitals and the medical directors violated the federal False Claims Act by entering into certain arrangements that allegedly violated the federal anti-kickback statute and provisions of the Social Security Act prohibiting physician self-referrals. Although no specific monetary damage has been claimed, the plaintiff, on behalf of the federal government, seeks treble damages plus civil penalties and attorneys fees. The plaintiff also has requested an award of 30% of any judgment plus expenses. In February 2006, WPMC filed an arbitration claim seeking indemnification from us for certain costs and expenses incurred by it in connection with the case.

In the action by the former employee, discovery is substantially complete but no trial date has been set. The parties have had initial discussions regarding their respective positions in the case; however, no resolution of this case has been reached or can be assured prior to the case proceeding to trial. In the action by WPMC, initial arbitration proceedings were commenced during the third quarter of fiscal 2006.

We believe that we have conducted our operations in full compliance with applicable statutory requirements and that we have meritorious defenses to the claims made in the case and the related arbitration proceeding, and intend to contest the claims vigorously. Nevertheless, it is possible that resolution of these legal matters could have a material adverse effect on our consolidated results of operations in a particular financial reporting period. We believe that we will continue to incur legal expenses associated with the defense of these matters which may be material to our consolidated results of operations in a particular financial reporting period. However, we believe that any resolution of this case and all related matters will not have a material effect on our liquidity or financial condition.

We are also subject to other claims and suits that arise from time to time in the ordinary course of our business. While management currently believes that resolving claims against us, individually or in aggregate, will not have a material adverse impact on our financial position, our results of operations, or our cash flows, these matters are subject to inherent uncertainties, and management s view of these matters may change in the future.

(8) Comprehensive Income

Comprehensive income, net of income taxes, was $11.9 million and $6.5 million for the three months ended November 30, 2006 and 2005, respectively.

(9) Subsequent Events

On December 1, 2006, we acquired Axia Health Management, Inc. (Axia), a national provider of preventive health and wellness programs, for approximately $458.0 million in cash. At the closing, we deposited $35.0 million of the purchase price to be held in escrow until approximately December 31, 2007 to satisfy any potential indemnification claims. We also deposited an additional $9.0 million of the purchase price to be held in escrow to satisfy a portion of certain potential earnout obligations owed to certain persons who had previously sold certain businesses to Axia. We funded the acquisition through the use of approximately $108.0 million in cash and $350.0 million in borrowings under a $600.0 million credit facility, as discussed below.

On December 1, 2006, we entered into a Third Amended and Restated Revolving Credit and Term Loan Agreement (the Third Amended Credit Agreement). The Third Amended Credit Agreement provides us with a $400.0 million revolving credit facility, including a swingline sub facility of $10.0 million and a $75.0 million sub facility for letters of credit, a $200.0 million term loan facility, and an uncommitted incremental accordion facility of $200.0 million.

Revolving advances under the Third Amended Credit Agreement generally bear interest, at our option, at 1) LIBOR plus a spread of 0.875% to 1.750% or 2) the greater of the federal funds rate plus 0.5%, or the prime rate, plus a spread of 0.000% to 0.250%. Term loan borrowings under the Third Amended Credit Agreement generally bear interest, at our option, at 1) LIBOR plus 1.750% or 2) the greater of the federal funds rate plus 0.5%, or the prime rate, plus 0.250%. The Third Amended Credit Agreement also provides for a fee ranging between 0.150% and 0.300% of unused commitments. The Third Amended Credit Agreement is secured by guarantees from most of the Company s 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 on the revolving commitment termination date, which is December 1, 2011. We are required to repay term loans in quarterly principal installments aggregating $0.5 million each, commencing on March 31, 2007, and the entire unpaid principal balance of the term loans is due and payable at maturity on December 1, 2013.

The Third Amended Credit Agreement contains various financial covenants, which require us to maintain, as defined, ratios or levels of (i) total funded debt to EBITDA, (ii) fixed charge coverage, and (iii) net worth. It also restricts the payment of dividends and limits the amount of repurchases of the Company s common stock. On December 21, 2006, we entered into an amortizing fixed interest rate swap agreement for the management of interest rate exposure. By entering into this interest rate swap agreement we effectively converted $230.0 million of floating rate debt to a fixed obligation with an interest rate of 4.995%. The principal value of the swap arrangement amortizes over a 39-month period and terminates on March 31, 2010. We currently believe that we will be able to meet the hedge accounting criteria under SFAS No. 133 in accounting for the interest rate swap agreement.

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

Overview

Founded in 1981, Healthways, Inc. (the Company) provides specialized, comprehensive Health and Care Support[SM] programs and services, including disease management, high-risk care management and Outcomes Driven Wellness[SM] programs to health plans, governments, employers, and hospitals in all 50 states, the District of Columbia, Puerto Rico, and Guam. These services include, but are not limited to:

- providing members with educational materials and personal interactions with highly trained nurses and other health-care professionals designed to create and sustain healthier behaviors;
- incorporating current evidence-based clinical guidelines in interventions to optimize patient care;
- developing care support plans and motivating members to set attainable goals for themselves;
- providing local market resources to address acute episode interventions;
- coordinating members care with local health-care providers; and
- fostering wellness and prevention through total population screening, health risk assessments, and supportive interventions.

Our integrated Health and Care Support programs serve entire customer populations through member and physician Health and Care Support interventions, advanced neural network predictive modeling, and a confidential, secure Internet-based application that provides patients and physicians with individualized health information. Our programs enable our customers to develop relationships with all of their members and to identify those at highest risk for a health problem, allowing for early interventions.

Our programs are designed to help people lead healthier lives by making sure they understand and follow doctors orders including medication compliance, are aware of and can recognize early warning signs associated with a major health episode, and are setting achievable goals for themselves to improve their current health status.

We believe that our patient and physician support regimens, delivered and/or supervised by a multi-disciplinary team, have demonstrated that they assist in providing more effective care for the enrollee populations diagnosed with one or more diseases or conditions, which will improve the health status of the enrollee populations with the disease or condition and reduce both the short-term and long-term health-care costs for these enrollees. In addition, our consumer-directed health support services enable health plans and employers to reach and engage everyone in their covered populations through interventions which are sensitive and specific to each individual s health risks and needs, thereby motivating behavior change and generating measurable cost savings.

Our integrated Health and Care Support product line includes programs for people with diabetes, coronary artery disease, heart failure, asthma, chronic obstructive pulmonary disease, end-stage renal disease, cancer, chronic kidney disease, depression, tobacco addiction, high-risk obesity, acid-related stomach disorders, atrial fibrillation, decubitus ulcer, fibromyalgia, hepatitis C, inflammatory bowel disease, irritable bowel syndrome, low-back pain, osteoarthritis, osteoporosis, and urinary incontinence. We also provide high-risk care management and population health support. We design our programs to create and maintain key desired behaviors of each program member and of the providers who care for them in order to improve member health status, thereby reducing health-care costs. The programs incorporate interventions designed to optimize member care and are based on the most up-to-date, evidence-based clinical guidelines.

The flexibility of our programs allows customers to enter the Health and Care Support market at the level they deem appropriate for their organization. Customers may select a single chronic disease or a total-population approach, in which all members of the customer s population receive the benefit of our programs at a single cost.

On December 1, 2006, we acquired Axia, a national provider of preventive health and wellness programs, for approximately $458.0 million in cash. At the closing, we deposited $35.0 million of the purchase price to be held in escrow until approximately December 31, 2007 to satisfy any potential indemnification claims. We also deposited an additional $9.0 million of the purchase price to be held in escrow to satisfy a portion of certain potential earnout obligations owed to certain persons who had previously sold certain business units to Axia. We financed the acquisition through a combination of cash on hand and borrowings under a $600.0 million credit facility, as discussed below in Liquidity and Capital Resources.

Highlights of Performance for the Three Months Ended November 30, 2006

Revenues increased 29.2% for the three months ended November 30, 2006 over the three months ended November 30, 2005.

Net income for the three months ended November 30, 2006 increased 83.3% over the three months ended November 30, 2005.

Actual lives under management increased 35.7% from November 30, 2005 to November 30, 2006, which included a 45.2% increase in self-insured employer actual lives under management to 967,000 at November 30, 2006 from – 666,000 at November 30, 2005.

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 and involve a number of risks and uncertainties. Forward-looking statements include all statements that do not relate solely to historical or current facts, and can be identified by the use of words like may, believe, will, expect, project, estimate, anticipate, plan, or continue. In order for us to use the safe harbor provisions of the Private Securities Litigation Reform Act of 1995, we caution you that the following important factors, among others, may affect these forward-looking statements. Consequently, actual operations and results may differ materially from those expressed in the forward-looking statements. The important factors include but are not limited to:

our ability to sign and implement new contracts for Health and Care Support services;

our ability to accurately forecast performance and the timing of revenue recognition under the terms of our contracts ahead of data collection and reconciliation in order to provide forward-looking guidance;

the timing and costs of implementation, and the effect, of regulations and interpretations relating to the Medicare Prescription Drug, Improvement, and Modernization Act of 2003;

our ability to anticipate the rate of market acceptance of Health and Care Support solutions and the individual market dynamics in potential international markets and our ability to accurately forecast the costs necessary to implement our strategy of establishing a presence in these markets;

the risks associated with foreign currency exchange rate fluctuations and our ability to hedge against such fluctuations;

our ability to effectively manage any growth that we might experience;

our ability to retain existing health plan customers if they decide to take programs in-house or are acquired by other health plans which already have or are not interested in Health and Care Support programs;

the risks associated with a significant concentration of our revenues with a limited number of customers;

our ability to effect cost savings and clinical outcomes improvements under Health and Care Support contracts and reach mutual agreement with customers with respect to cost savings, or to effect such savings and improvements within the time frames contemplated by us;

our ability to collect contractually earned performance incentive bonuses;

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;

increased leverage incurred in conjunction with the acquisition of Axia and our ability to service our debt and make principal and interest payments as those payments become due;

our ability to integrate the operations of Axia and other acquired businesses or technologies into our business and to achieve the results provided in our guidance with respect to Axia;

our ability to develop new products and deliver outcomes on those products, including those anticipated from our strategic relationship with Medco, Inc.;

our ability to effectively integrate new technologies and approaches, such as those encompassed in our Health and Care Support initiatives or otherwise licensed or acquired by us, into our Health and Care Support platform;

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 implement our Health and Care Support strategy within expected cost estimates;

our ability to obtain adequate financing to provide the capital that may be necessary to support the growth of our operations and to support or guarantee our performance under new contracts;

unusual and unforeseen patterns of health care utilization by individuals with diabetes, cardiac, respiratory and/or other 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;

our ability to attract and/or retain and effectively manage the employees required to implement our agreements;

the impact of litigation involving us and/or our subsidiaries;

the impact of future state and federal health care and other applicable legislation and regulations 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 and the continuing threat of domestic or international terrorism;

general worldwide and domestic economic conditions and stock market volatility; and

other risks detailed in our other filings with the Securities and Exchange Commission.

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

Customer Contracts

Contract Terms

We generally determine our contract fees by multiplying a contractually negotiated rate per member per month (PMPM) by the number of members covered by our services during the month. We set the 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 some contracts, the PMPM rates may differ between a customer s lines of business [e.g. Preferred Provider Organizations (PPO), Health Maintenance Organizations (HMO), Medicare Advantage]. Contracts with health plans generally range from three to seven years with provisions for subsequent renewal; contracts between our health plan customers and their self-insured employer accounts typically have one-year terms. Some contracts allow the customer to terminate early under certain conditions.

Some contracts provide that a portion (up to 100%) of our fees may be refundable to the customer (performance-based) if our programs do not achieve, when compared to a baseline year, a targeted percentage reduction in the customer s health-care costs and selected clinical and/or other criteria that focus on improving the health of the members. Approximately 7% of revenues recorded during the three months ended November 30, 2006 were performance-based and were subject to final reconciliation as of November 30, 2006. We anticipate that this percentage will fluctuate due to the level of performance-based fees in new contracts, revenue recognition associated with performance-based fees, and the timing of data reconciliation, which varies according to contract terms. A limited number of contracts also provide opportunities for us to receive incentive bonuses in excess of the contractual PMPM rate if we exceed contractual performance targets.

We are participating in two Medicare Health Support (MHS) pilots awarded under the Chronic Care Improvement Program authorized by the Medicare Modernization Act of 2003. The pilots will operate for 36 months and may be terminated by either party with six months written notice. We began operating one pilot in August 2005 to serve 20,000 Medicare fee-for-service beneficiaries in Maryland and the District of Columbia. All fees under this pilot are performance-based. In addition, in September 2005 we began serving 20,000 beneficiaries in Georgia in collaboration with CIGNA HealthCare, Inc. The majority of our fees under our contract with CIGNA are performance-based. Both of the pilots are for complex diabetes and congestive heart failure disease management services and are operationally similar to our programs for commercial and Medicare Advantage health plan populations.

In June 2006, we signed an amendment to our cooperative agreement with the Centers for Medicare & Medicaid Services (CMS) for our MHS stand-alone pilot in Maryland and the District of Columbia, which, among other things, enabled us to provide congestive heart failure programs to approximately 4,500 additional Medicare fee-for-service beneficiaries for two years beginning on August 1, 2006 (the refresh population). All fees for the refresh population are performance-based.

Information Systems

Our contracts require sophisticated management information systems to help us manage the care of large populations with targeted chronic diseases or other medical conditions and to report the impact of our programs on clinical and financial outcomes. We have developed and are continually expanding and improving our proprietary clinical, data management, and reporting systems, to continue to meet our information management needs for our Health and Care Support services. Due to the anticipated expansion and improvement in our information management systems, we expect to continue making significant investments in our information technology software and hardware and in our information technology staff.

Contract Revenues

Our contract revenues depend on the contractual terms we establish and maintain with customers to provide Health and Care Support services to their members. Some contracts allow the customer to terminate early under certain conditions. Restructurings and possible terminations at or prior to renewal could have a material negative impact on our results of operations and financial condition.

Approximately 28% of our revenues for the three months ended November 30, 2006 were derived from one customer that comprised more than 10% of our revenues for the period. The loss of this customer or any other large customer or a reduction in the profitability of any contract with this customer would have a material negative impact on our results of operations, cash flows, and financial condition.

Actual Lives under Management

We measure the volume of participation in our programs by the actual number of people who are benefiting from our services, which is reported as actual lives under management. Backlog represents the estimated annualized revenue at target performance associated with signed contracts at November 30, 2006 for which we have not yet begun providing services. The number of actual lives under management and annualized revenue in backlog are shown below at November 30, 2006 and November 30, 2005.

At November 30,	2006	2005
Actual lives under management	2,462,000	1,814,000
Annualized revenue in backlog (in $000s)	$ 7,867	$ 40,172

We have seen increasing demand for our Health and Care Support services from self-insured employer accounts, most of which are contracted through the Administrative Services Only (ASO) line of business with our health plan customers and for which our health plan customers do not assume medical cost risk but provide primarily administrative claim and health network access services. Signed contracts between these self-insured employers and our health plan customers are incorporated in our contracts with our health plan customers, and these program-eligible members are included in the lives under management or the annualized revenue in backlog reported in the table above, as appropriate.

Business Strategy

Our primary strategy is to create value for health plans, governments, employers, and hospitals through Health and Care Support programs and services that improve the quality and affordability of health-care. We plan to continue using our scaleable state-of-the-art care enhancement centers, medical information content, and proprietary technologies to gain a competitive advantage in delivering our Health and Care Support services.

We expect to continue adding services to our product mix that extend our programs beyond a chronic disease focus and provide services to individuals who currently have, or face the risk of developing, one or more additional medical conditions. We believe that we can achieve improvements in care and significant cost savings by addressing care and treatment requirements for these additional selected diseases and conditions and by providing wellness and preventive programs, which will enable us to address an increasingly larger percentage of a customer s population and total health-care costs. In December 2006, we acquired Axia, a national provider of preventive health and wellness programs, which we believe furthers our continuing strategy to provide, or enable our customers to provide, a full

spectrum of integrated, personalized, proven and evidence-based interventions to maintain or improve health and productivity.

In May 2006 we entered into a strategic partnership with Medco, Inc., a pharmacy benefit management company, to distribute existing programs and to develop and distribute integrated medical and pharmaceutical management programs. We expect to continue developing proprietary, proactive health support products and services for whole populations across the continuum of care, including next generation integrated disease management and wellness solutions.

We anticipate that we will incur significant costs during the remainder of fiscal 2007 to enhance and expand our clinical programs and data and financial reporting systems, pursue opportunities in international markets, enhance our information technology support, integrate the operations of Axia, and open additional or expand current care enhancement centers as needed. We may add some of these new capabilities and technologies through internal development, strategic alliances with other entities and/or through selective acquisitions.

Critical Accounting Policies

We describe our accounting policies in Note 1 of the Notes to the Consolidated Financial Statements included in our Annual Report on Form 10-K for the fiscal year ended August 31, 2006. We prepare the consolidated financial statements in conformity with U.S. generally accepted accounting principles, which require 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 results of operations, financial condition and cash flows.

Revenue Recognition

We generally determine our contract fees by multiplying a contractually negotiated rate per member per month (PMPM) by the number of members covered by our services during the month. We set the 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 some contracts, the PMPM rates may differ between a customer s lines of business (e.g., PPO, HMO, Medicare Advantage). Contracts with health plans generally range from three to seven years with provisions for subsequent renewal; contracts between our health plan customers and their self-insured employer accounts typically have one-year terms.

Some contracts provide that a portion (up to 100%) of our fees may be refundable to the customer (performance-based) if our programs do not achieve, when compared to a baseline year, a targeted percentage reduction in the customer s health-care costs and selected clinical and/or other criteria that focus on improving the health of the members. Approximately 7% of revenues recorded during the three months ended November 30, 2006 were performance-based and were subject to final reconciliation as of November 30, 2006. We anticipate that this percentage will fluctuate due to the level of performance-based fees in new contracts, revenue recognition associated with performance-based fees, and the timing of data reconciliation, which varies according to contract terms. A limited number of contracts also provide opportunities for us to receive incentive bonuses in excess of the contractual PMPM rate if we exceed contractual performance targets.

We 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. Contractually, we cannot bill for any incentive bonus until after contract settlement.

We recognize revenue as follows: 1) we recognize the fixed portion of the monthly fees as revenue during the period we perform our services; 2) we recognize the performance-based portion of the monthly fees 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; and 3) we recognize additional incentive bonuses based on the most recent assessment of our performance, to the extent we consider such amounts collectible.

We 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 six 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 reserves, when appropriate, for billing adjustments at contract reconciliation.

Substantially all of the fees under both the MHS pilots and the refresh population in which we are participating are performance-based. The pilots require that, by the end of the third year, we achieve a cumulative net savings (total savings for the intervention population as compared to the control group less fees received from CMS) of 5.0%. The cumulative net savings targets are lower at the beginning of the pilots and increase in gradual increments, ending with a cumulative net savings target of 5.0% at the end of the pilots. Under the amendment of our stand-alone MHS pilot in Maryland and the District of Columbia, the refresh population will be a separate cohort served for two years, by the end of which the program is expected to achieve a 2.5% cumulative net savings when compared to a new control cohort. Under the stand-alone pilot, savings in excess of target achieved in either the original cohort or the refresh cohort can be applied against any savings deficit that might occur in the other cohort. Although we receive the medical claims and other data associated with the intervention group under these pilots on a monthly basis, we assess our performance against the control group under these pilots based on quarterly performance reports received from CMS financial reconciliation contractor.

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 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 health-care claims and clinical data. As of November 30, 2006, performance-based fees that have not yet been settled with our customers but that have been recognized as revenue in the current and prior years, including performance-based fees recognized as revenue under the MHS pilots, which will not be settled with the customer until the end of the pilots, totaled approximately $57.7 million. Of this amount, $20.5 million was based on calculations which include estimates such as medical claims incurred but not reported and/or the customer s medical cost trend compared to a baseline year, while $37.2 million was based entirely 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, data reconciliation differences, or adjustments to incentive bonuses may cause us to recognize or reverse revenue in a current fiscal year that pertains to services provided during the prior fiscal year. During the three months ended November 30, 2006, we recognized a net decrease in revenue of $0.8 million that related to services provided prior to fiscal 2007.

Impairment of Intangible Assets and Goodwill

In accordance with SFAS No. 142, Goodwill and Other Intangible Assets, we review goodwill for impairment on an annual basis or more frequently whenever events or circumstances indicate that the carrying value may not be recoverable.

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 SFAS No. 142. Fair value is the amount at which the asset could be bought or sold in a current transaction between two willing parties. We estimate fair value using a number of techniques, including quoted market prices or valuations by third parties, present value techniques based on estimates of cash flows, or multiples of earnings or revenues performance measures.

We amortize other identifiable intangible assets, such as acquired technologies and customer contracts, on the straight-line method over their estimated useful lives, except for trade names, which have an indefinite life and are not subject to amortization. We review intangible assets not subject to amortization on an annual basis or more frequently whenever events or circumstances indicate that the assets might be impaired. 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 projected net cash flows expected to result from that asset, including eventual disposition.

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

Share-Based Compensation

In accordance with SFAS No. 123(R), 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 share-based awards 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. We contract with a third party to assist in developing the assumptions used in estimating the fair values of stock options.

Results of Operations

The following table shows the components of the statements of operations for the three months ended November 30, 2006 and 2005 expressed as a percentage of revenues.

	Three Months Ended November 30,	
	2006	2005
Revenues	100.0%	100.0%
Cost of services (exclusive of depreciation and amortization below)	66.3%	70.5%
Selling, general and administrative expenses	10.8%	11.2%
Depreciation and amortization	5.8%	6.2%
Operating income	17.2%	12.1%
Interest expense	0.3%	0.3%
Income before income taxes	16.9%	11.8%
Income tax expense	6.8%	4.7%
Net income	10.1%	7.1%

Revenues

Revenues for the three months ended November 30, 2006 increased 29.2% over revenues for the three months ended November 30, 2005, primarily due to the following:

an increase in the number of self-insured employer actual lives under management from 666,000 at November 30, 2005 to 967,000 at November 30, 2006;

existing health plan customers adding or expanding eight new programs since the beginning of the first quarter of fiscal 2006;

the commencement of seven new health plan contracts since the beginning of the first quarter of fiscal 2006; and

increased membership in our customers existing programs.

We anticipate that revenues for the remainder of fiscal 2007 will increase over fiscal 2006 primarily due to the expansion of existing contracts, increasing demand for our Health and Care Support services from self-insured employers who contract with our health plan customers or with Medco, anticipated new health plan contracts, increased revenues from the MHS pilots and the acquisition of Axia.

Cost of Services

Cost of services (excluding depreciation and amortization) as a percentage of revenues for the three months ended November 30, 2006 decreased to 66.3% compared to 70.5% for the same period in fiscal 2006, primarily due to the following:

a decrease in the level of employee bonus provision during the three months ended November 30, 2006 compared to the three months ended November 30, 2005;

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a decrease in telecommunications expense during the three months ended November 30, 2006 compared to the three months ended November 30, 2005 primarily due to the renegotiation of a telecommunications contract resulting in cost savings beginning in the second quarter of fiscal 2006; and

improvement in our medical claims experience under our self-insured health insurance program during the three months ended November 30, 2006 compared to the three months ended November 30, 2005.

These decreases were somewhat offset by increases in cost of services as a percentage of revenues related to the following:

increased professional consulting fees related to information technology strategy and initiatives during the three months ended November 30, 2006 compared to the three months ended November 30, 2005;

increased volume in mailings of educational materials to participants due to timing of new contracts and an increase in domestic postage rates during the three months ended November 30, 2006 compared to the three months ended November 30, 2005;

increased salaries and benefits during the three months ended November 30, 2006 compared to the three months ended November 30, 2005 primarily related to organizational design changes in our field support and operations structure; and

increased costs and decreased revenues related to the MHS pilots during the three months ended November 30, 2006 compared to the three months ended November 30, 2005. Costs associated with the MHS pilots increased primarily due to 1) additional costs related to the timing of the pilot in Georgia in collaboration with CIGNA, which did not begin until the middle of the first quarter of fiscal 2006; 2) enhanced interventions to generate cost savings in the pilots, such as through the increased use of heart monitors; and 3) additional costs related to the refresh population, which we began serving on August 1, 2006. Revenues associated with the MHS pilots decreased due to a decline in the cumulative net savings in the intervention population compared to the control group.

We anticipate that cost of services for the remainder of fiscal 2007 will increase over fiscal 2006 primarily as a result of increases in operating staff required for expected increases in demand for our services, increases in indirect staff costs associated with the continuing development and implementation of our Health and Care Support services, increases in information technology and other support staff and costs, and the incremental cost of services attributable to Axia, including related operational integration expenses.

Selling, General and Administrative Expenses

Selling, general and administrative expenses as a percentage of revenues decreased to 10.8% for the three months ended November 30, 2006 compared to 11.2% for the same period in fiscal 2006 primarily related to a decrease in the level of employee bonus provision during the three months ended November 30, 2006 compared to the three months ended November 30, 2005. This decrease was somewhat offset by increased salaries and benefits related to our marketing and sales strategy initiatives during the three months ended November 30, 2006 compared to the three months ended November 30, 2005.

We anticipate that selling, general and administrative expenses for the remainder of fiscal 2007 will increase over fiscal 2006 primarily due to anticipated investments in international initiatives, increases in selling and general administrative costs in support of our existing and anticipated new and expanded contracts, incremental selling, general and administrative costs attributable to Axia, and costs related to the integration of Axia.

Depreciation and Amortization

Depreciation and amortization expense for the three months ended November 30, 2006 increased 20.4% compared to the same period in fiscal 2006 primarily due to increased depreciation expense associated with capital expenditures to enhance our information technology capabilities and expand our corporate office and calling capacity at existing care enhancement centers.

We anticipate that depreciation and amortization expense for the remainder of fiscal 2007 will increase over fiscal 2006 primarily as a result of 1) anticipated depreciation and amortization expense associated with the estimated identifiable intangible assets and depreciable assets expected to be recorded in connection with the Axia acquisition, and 2) additional capital expenditures associated with expected increases in demand for our services and growth and improvement in our information technology capabilities.

Interest Expense

We anticipate that interest expense for the remainder of fiscal 2007 will increase over fiscal 2006 primarily as a result of borrowings under the Third Amended Credit Agreement entered into on December 1, 2006.

Income Tax Expense

Our effective tax rate increased to 40.3% for the three months ended November 30, 2006 compared to 39.7% for the three months ended November 30, 2005, primarily as a result of costs of international initiatives and changes in our geographic mix of earnings, which impacts our average state income tax rate, and other factors. The differences between the statutory federal income tax rate of 35.0% and our effective tax rate are due primarily to the impact of state income taxes and certain non-deductible expenses for income tax purposes. We anticipate that our effective tax rate for the remainder of fiscal 2007 will increase over fiscal 2006 primarily as a result of an expected increase in costs related to international initiatives in fiscal 2007.

Liquidity and Capital Resources

Operating activities for the three months ended November 30, 2006 generated cash of $9.4 million compared to $4.5 million for the same period in fiscal 2006. The increase in operating cash flow of $4.9 million resulted primarily from 1) an increase in net income; 2) a decrease in cash collections on accounts receivable during the three months ended November 30, 2005 due to a delay in monthly payments from two large customers, which were received in early December 2005; and 3) an increase in accounts payable during the three months ended November 30, 2006 compared to the three months ended November 30, 2005 related to several large vendor invoices that were received in November 2006 and paid in early December 2006. These increases to cash were partially offset by a higher employee bonus payment during the three months ended November 30, 2006 compared to the three months ended November 30, 2005.

Investing activities during the three months ended November 30, 2006 used $4.7 million in cash which primarily consisted of investments in property and equipment associated with the addition of information technology hardware and software and expansions at existing care enhancement centers.

Financing activities for the three months ended November 30, 2006 provided $2.5 million in cash primarily due to proceeds from the exercise of stock options and the related tax benefit.

As of November 30, 2006, there were letters of credit outstanding under the Second Amended Credit Agreement totaling $0.9 million primarily to secure our ability to pay claims under our workers compensation high-deductible policy.

As of November 30, 2006, we were in compliance with all of the covenant requirements of the Second Amended Credit Agreement, and we are currently in compliance with all of the covenant requirements of the Third Amended Credit Agreement, as described further below. As of November 30, 2006, our available line of credit totaled $249.1 million. In December 2006, we used approximately $108.0 million in cash and $350.0 million in borrowings under a $600.0 million credit facility, discussed below, to fund the Axia acquisition.

On December 1, 2006, we entered into the Third Amended Credit Agreement. The Third Amended Credit Agreement provides us with a $400.0 million revolving credit facility, including a swingline sub facility of $10.0 million and a $75.0 million sub facility for letters of credit, a $200.0 million term loan facility, and an uncommitted incremental accordion facility of $200.0 million.

Revolving advances under the Third Amended Credit Agreement generally bear interest, at our option, at 1) LIBOR plus a spread of 0.875% to 1.750% or 2) the greater of the federal funds rate plus 0.5%, or the prime rate, plus a spread of 0.000% to 0.250%. Term loan borrowings under the Third Amended Credit Agreement generally bear interest, at our option, at 1) LIBOR plus 1.750% or 2) the greater of the federal funds rate plus 0.5%, or the prime rate, plus 0.250%. The Third Amended Credit Agreement also provides for a fee ranging between 0.150% and 0.300% of unused commitments. The Third Amended Credit Agreement is secured by guarantees from most of the Company s 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 on the revolving commitment termination date, which is December 1, 2011. We are required to repay term loans in quarterly principal installments aggregating $0.5 million each, commencing on March 31, 2007, and the entire unpaid principal balance of the term loans is due and payable at maturity on December 1, 2013.

The Third Amended Credit Agreement replaced the Second Amended Credit Agreement, which provided us with a $250.0 million revolving credit facility, including a swingline sub facility of $10.0 million and a $75.0 million sub facility for letters of credit, together with an uncommitted incremental accordion facility of $50.0 million. The Second Amended Credit Agreement contained various financial covenants, which required us to maintain, as defined, ratios or levels of (i) total funded debt to EBITDA, (ii) fixed charge coverage, and (iii) net worth. The Third Amended Credit Agreement contains similar financial covenants. Both agreements restrict the payment of dividends and limit the amount of repurchases of the Company s common stock. On December 21, 2006, we entered into an amortizing fixed interest rate swap agreement for the management of interest rate exposure. By entering into this interest rate swap agreement we effectively converted $230.0 million of floating rate debt to a fixed obligation with an interest rate of 4.995%. The principal value of the swap arrangement amortizes over a 39-month period and terminates on March 31, 2010. We currently believe that we will be able to meet the hedge accounting criteria under SFAS No. 133 in accounting for the interest rate swap agreement.

We believe that cash flow from operating activities, our available cash, and our expected available credit under committed bank debt will continue to enable us to meet our contractual obligations and to fund the current level of growth in our operations for the foreseeable future. However, if

expanding our operations requires significant additional financing resources, such as capital expenditures for technology improvements, additional care enhancement 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 expand our operations.

If contract development accelerates or acquisition opportunities arise that would expand our operations, 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.

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 Second Amended Credit Agreement, which bears interest based on floating rates. Borrowings under the Second Amended Credit Agreement generally bear interest, at our option, at LIBOR plus a spread of 0.875% to 1.5%, which is dependent on the ratio of total funded debt to EBITDA, or at the prime rate. Because there was no variable rate debt outstanding during the three months ended November 30, 2006, a one-point interest rate change would not have caused interest expense to fluctuate for the three months ended November 30, 2006.

As of November 30, 2006, 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, a 10% change in foreign currency exchange rates would not have had a material impact on our results of operations or financial position for the three months ended November 30, 2006. 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 Rules 13a-15(e) and 15d-15(e) promulgated under the Securities Exchange Act of 1934 (the Exchange Act)) as of November 30, 2006. Based on that evaluation, the chief executive officer and chief financial officer have concluded that our disclosure controls and procedures effectively and timely provide them with material information relating to the Company and its consolidated subsidiaries required to be disclosed in the reports the Company files or submits under the Exchange Act.

Changes in Internal Control over Financial Reporting

There have been no changes in our internal controls over financial reporting during the quarter ended November 30, 2006 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Part II

Item 1. Legal Proceedings.

In June 1994, a former employee whom we dismissed in February 1994 filed a whistle blower action on behalf of the United States government. Subsequent to its review of this case, the federal government determined not to intervene in the litigation. The employee sued Healthways, Inc. and our wholly-owned subsidiary, American Healthways Services, Inc. (AHSI), as well as certain named and unnamed medical directors and one named client hospital, West Paces Medical Center (WPMC), and other unnamed client hospitals.

Healthways, Inc. has since been dismissed as a defendant; however, the case is still pending against AHSI before the United States District Court for the District of Columbia. In addition, WPMC has settled claims filed against it as part of a larger settlement agreement that WPMC s parent organization, HCA Inc., reached with the United States government.

The complaint alleges that AHSI, the client hospitals and the medical directors violated the federal False Claims Act by entering into certain arrangements that allegedly violated the federal anti-kickback statute and provisions of the Social Security Act prohibiting physician self-referrals. Although no specific monetary damage