

ATHENAHEALTH INC  
Form 10-Q  
October 22, 2010

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

(Mark One)

**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, 2010

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 001-33689

**athenahealth, Inc.**

(Exact name of registrant as specified in its charter)

Delaware

04-3387530

(State or other jurisdiction of incorporation or organization)

(I.R.S. Employer Identification No.)

311 Arsenal Street, Watertown, Massachusetts

02472

(Address of principal executive offices)

(Zip Code)

617-402-1000

(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 the 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

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As of October 20, 2010, there were 34,266,585 shares of the registrant's \$0.01 par value common stock outstanding.

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**PART I FINANCIAL INFORMATION****Item 1. Condensed Consolidated Financial Statements (unaudited).****athenahealth, Inc.****CONDENSED CONSOLIDATED BALANCE SHEETS****(Unaudited, in thousands, except per-share amounts)**

	September 30, 2010	December 31, 2009
Assets		
Current assets:		
Cash and cash equivalents	\$ 24,054	\$ 30,526
Short-term investments	73,560	52,323
Accounts receivable - net	36,151	33,323
Deferred tax assets	3,945	5,544
Prepaid expenses and other current assets	6,635	4,663
Total current assets	144,345	126,379
Property and equipment - net	32,389	24,871
Restricted cash	8,885	9,216
Software development costs - net	2,954	2,324
Purchased intangibles - net	13,111	14,490
Goodwill	22,407	22,120
Deferred tax assets	14,217	10,284
Other assets	3,235	1,393
Total assets	\$ 241,543	\$ 211,077
Liabilities & Stockholders' Equity		
Current liabilities:		
Current portion of long-term debt and capital lease obligations	\$ 3,116	\$ 3,437
Accounts payable	1,102	1,880
Accrued compensation	16,608	15,774
Accrued expenses	10,827	10,781
Current portion of deferred revenue	5,408	4,038
Interest rate derivative liability	766	291
Current portion of deferred rent	1,369	1,288
Total current liabilities	39,196	37,489
Deferred revenue, net of current portion	33,766	28,684
Other long-term liabilities	1,681	1,191
Deferred rent, net of current portion	6,403	7,444
Debt and capital lease obligations, net of current portion	6,943	8,951
Total liabilities	87,989	83,759
Commitments and contingencies (note 12)		

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Stockholders' equity:		
Preferred stock, \$0.01 par value: 5,000 shares authorized; no shares issued and outstanding at September 30, 2010 and December 31, 2009, respectively	-	-
Common stock, \$0.01 par value: 125,000 shares authorized; 35,519 shares issued, and 34,241 shares outstanding at September 30, 2010; 35,166 shares issued and 33,888 shares outstanding at December 31, 2009.	355	352
Additional paid-in capital	190,588	169,715
Treasury stock, at cost, 1,278 shares	(1,200)	(1,200)
Accumulated other comprehensive loss	(114)	(73)
Accumulated deficit	(36,075)	(41,476)
 Total stockholders' equity	 153,554	 127,318
 Total liabilities and stockholders' equity	 \$ 241,543	 \$ 211,077

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

**athenahealth, Inc.****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS****(Unaudited, in thousands, except per-share amounts)**

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009 (as restated)(1)	2010	2009 (as restated)(1)
<b>Revenue:</b>				
Business services	\$ 61,087	\$ 45,609	\$ 170,051	\$ 129,933
Implementation and other	2,056	1,796	6,121	4,148
Total revenue	63,143	47,405	176,172	134,081
<b>Expense:</b>				
Direct operating	24,543	19,942	72,163	57,900
Selling and marketing	13,233	8,963	37,986	24,850
Research and development	4,645	3,748	13,543	10,368
General and administrative	10,390	9,732	33,470	26,327
Depreciation and amortization	2,869	2,098	7,946	5,535
Total expense	55,680	44,483	165,108	124,980
Operating income	7,463	2,922	11,064	9,101
<b>Other income (expense):</b>				
Interest income	75	216	219	938
Interest expense	(102)	(270)	(437)	(727)
(Loss) gain on interest rate derivative contract	(111)	(125)	(475)	375
Other income	33	96	96	211
Total other (expense) income	(105)	(83)	(597)	797
Income before income taxes	7,358	2,839	10,467	9,898
Income tax provision	(3,532)	(1,673)	(5,066)	(4,950)
Net income	\$ 3,826	\$ 1,166	\$ 5,401	\$ 4,948
Net income per share - Basic	\$ 0.11	\$ 0.03	\$ 0.16	\$ 0.15
Net income per share - Diluted	\$ 0.11	\$ 0.03	\$ 0.15	\$ 0.14

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Weighted average shares used in computing net income per share:

Basic	34,174	33,610	34,101	33,520
Diluted	35,156	34,900	35,179	34,707

(1) See Note 2 Restatement and Reclassification of Previously Issued Consolidated Financial Statements of Accompanying Notes to Condensed Consolidated Financial Statements.

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

**athenahealth, Inc.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(Unaudited, in thousands)**

	Nine Months Ended September 30,	
	2010	2009
		(as
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		restated)(1)
Net income	\$ 5,401	\$ 4,948
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	9,325	5,774
Amortization of premium (discounts) on investments	938	(366)
Provision for uncollectible accounts	575	369
Deferred income taxes	(2,334)	4,421
Excess tax benefit from stock-based awards	(5,981)	(1,705)
Increase in fair value of contingent consideration	304	-
Loss (gain) on interest rate derivative contract	475	(375)
Stock-based compensation expense	10,455	6,115
Changes in operating assets and liabilities:		
Accounts receivable	(3,403)	(3,983)
Prepaid expenses and other current assets	4,009	(1,335)
Other long-term assets	(341)	48
Accounts payable	(395)	412
Accrued expenses	779	3,116
Deferred revenue	6,452	4,907
Deferred rent	(960)	(811)
 Net cash provided by operating activities	 25,299	 21,535
 <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Capitalized software development costs	(2,426)	(1,759)
Purchases of property and equipment	(14,105)	(6,616)
Proceeds from sales and maturities of investments	78,502	58,000
Proceeds from sale or disposal of equipment	363	4,690
Purchases of investment in unconsolidated company	-	(550)
Purchases of short-term and long-term investments	(102,204)	(77,066)
Payments for acquisitions net of cash acquired	-	(131)
Decrease in restricted cash	331	332
 Net cash used in investing activities	 (39,539)	 (23,100)
 <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Proceeds from issuance of common stock under stock plans	4,440	1,654



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Payments on long-term debt and capital lease obligations	(2,692)	(2,978)
Excess tax benefit from stock-based awards	5,981	1,705
Net cash provided by financing activities	7,729	381
Effects of exchange rate changes on cash and cash equivalents	39	(276)
Net decrease in cash and cash equivalents	(6,472)	(1,460)
Cash and cash equivalents at beginning of period	30,526	28,933
Cash and cash equivalents at end of period	\$ 24,054	\$ 27,473
Supplemental disclosures of non-cash items - Property and equipment recorded in accounts payables and accrued expenses	\$ 127	\$ 871
Supplemental disclosures of cash flow information - Cash paid for interest	\$ 437	\$ 632
Cash paid for taxes	\$ 1,465	\$ 514
Property and equipment acquired under capital leases	\$ 363	\$ 4,690

(1) See Note 2 Restatement and Reclassification of Previously Issued Condensed Consolidated Financial Statements of Accompanying Notes to Condensed Consolidated Financial Statements.

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

**athenahealth, Inc.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited amounts in thousands, except per-share amounts)**

**1. BASIS OF PRESENTATION**

The accompanying unaudited condensed consolidated financial statements have been prepared by athenahealth, Inc. (the Company or we ) in accordance with accounting principles generally accepted in the United States ( GAAP ) for interim financial reporting and as required by Regulation S-X, Rule 10-01. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of the Company s management, the accompanying unaudited condensed consolidated financial statements contain all adjustments (consisting of items of a normal and recurring nature) necessary to present fairly the financial position as of September 30, 2010, and the results of operations for the three and nine month periods ended September 30, 2010 and 2009 and cash flows for the nine month periods ended September 30, 2010 and 2009. The results of operations for the three and nine month periods ended September 30, 2010 are not necessarily indicative of the results to be expected for the full year. When preparing financial statements in conformity with GAAP, we must make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, expenses, and related disclosures at the date of the financial statements. Actual results could differ from those estimates.

The Company considers events or transactions that occur after the balance sheet date but before the financial statements are issued to provide additional evidence relative to certain estimates or to identify matters that require additional disclosure. Subsequent events have been evaluated through the date of issuance of these financial statements. The accompanying unaudited condensed consolidated financial statements and notes thereto should be read in conjunction with the audited consolidated financial statements for the year ended December 31, 2009, included in our Annual Report on Form 10-K, which was filed with the Securities and Exchange Commission ( SEC ) on March 15, 2010.

**2. RESTATEMENT AND RECLASSIFICATION OF PREVIOUSLY ISSUED CONSOLIDATED FINANCIAL STATEMENTS**

On March 9, 2010, we concluded that we needed to restate our previously issued consolidated financial statements for the years ended December 31, 2008 and 2007. We also concluded that we needed to restate our previously issued condensed consolidated financial statements for the first, second, and third quarters of 2009. The restatement resulted primarily from a correction in the timing of revenue recognition of deferred implementation fees.

As part of the process to finalize our financial results for the year ended December 31, 2009, we undertook a comprehensive review of our significant accounting policies. As a result of our review, we concluded that, in prior and future periods, we will amortize deferred implementation revenue over a longer expected performance period of twelve years in order to reflect the estimated expected customer life. Previously, the expected performance period was estimated based upon the initial customer contract term, which, for the vast majority of contracts, was one year in duration. As a result of these adjustments, we also revised our previously calculated income tax expense for each quarter in 2009. All information presented in the condensed consolidated financial statements and the related notes include all such restatement adjustments.

In addition, in connection with the restatement, we have corrected previously issued financial statements for the three and nine months ended September 30, 2009, for reimbursements of out of pocket ( pass through ) expenses which were previously netted against operating expense have been grossed up and included in Implementation and other revenue in the consolidated statements of operations. This correction had no impact on net income or stockholders equity for any period.

The following tables summarize the effects of the restatement on our previously issued condensed consolidated financial statements:

## athenahealth, Inc.

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited amounts in thousands, except per-share amounts)

*Summary of increases (decreases) in Net Income*

	<b>Three Months Ended September 30, 2009</b>	<b>Nine Months Ended September 30, 2009</b>
<b>(in thousands, except per share amounts)</b>		
Net income, as previously reported	\$ 2,112	\$ 7,479
Net adjustments		
Implementation revenue	(1,577)	(4,219)
Income tax provision	631	1,688
Net income, restated	\$ 1,166	\$ 4,948
<b>Basic earning per common share:</b>		
Net income, as previously reported	\$ 0.06	\$ 0.22
Net adjustments		
Implementation revenue	(0.05)	(0.12)
Income tax provision	0.02	0.05
Net income, restated	\$ 0.03	\$ 0.15
<b>Diluted earning per common share:</b>		
Net income, as previously reported	\$ 0.06	\$ 0.22
Net adjustments		
Implementation revenue	(0.05)	(0.12)
Income tax provision	0.02	0.04
Net income, restated	\$ 0.03	\$ 0.14
Weighted average shares used in computing net income per share:		
Basic	33,610	33,520
Diluted	34,900	34,707

**athenahealth, Inc.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited amounts in thousands, except per-share amounts)***Condensed Consolidated Statement of Operations impact for the three months ended September 30, 2009*

	For the Three Months Ended September 30, 2009			
	As		As	
	Previously	Adjustments	Reclassifications	Restated
	Reported			
Revenue:				
Business services	\$ 45,609	\$ -	\$ -	\$ 45,609
Implementation and other	3,083	(1,577)	290	1,796
Total revenue	48,692	(1,577)	290	47,405
Expense:				
Direct operating	19,652	-	290	19,942
Selling and marketing	8,963	-	-	8,963
Research and development	3,748	-	-	3,748
General and administrative	9,732	-	-	9,732
Depreciation and amortization	2,098	-	-	2,098
Total expense	44,193	-	290	44,483
Operating income (loss)	4,499	(1,577)	-	2,922
Other income (expense):				
Interest income	216	-	-	216
Interest expense	(270)	-	-	(270)
Gain (loss) on interest rate derivative contract	(125)	-	-	(125)
Other income	96	-	-	96
Total other income (expense)	(83)	-	-	(83)
Income (loss) before income tax benefit	4,416	(1,577)	-	2,839
Income tax (provision) benefit	(2,304)	631	-	(1,673)
Net income	\$ 2,112	\$ (946)	\$ -	\$ 1,166
Net income per share - Basic	\$ 0.06	\$ (0.03)	\$ -	\$ 0.03
Net income per share - Diluted	\$ 0.06	\$ (0.03)	\$ -	\$ 0.03

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Weighted average shares used in  
computing net income per share:

Basic	33,610	33,610	33,610	33,610
Diluted	34,900	34,900	34,900	34,900

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**athenahealth, Inc.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited amounts in thousands, except per-share amounts)***Condensed Consolidated Statement of Operations impact for the nine months ended September 30, 2009*

	For the Nine Months Ended September 30, 2009			
	As			As
	Previously	Adjustments	Reclassifications	Restated
	Reported			
Revenue:				
Business services	\$ 129,933	\$ -	\$ -	\$ 129,933
Implementation and other	7,577	(4,219)	790	4,148
Total revenue	137,510	(4,219)	790	134,081
Expense:				
Direct operating	57,110	-	790	57,900
Selling and marketing	24,850	-	-	24,850
Research and development	10,368	-	-	10,368
General and administrative	26,327	-	-	26,327
Depreciation and amortization	5,535	-	-	5,535
Total expense	124,190	-	790	124,980
Operating income (loss)	13,320	(4,219)	-	9,101
Other income (expense):				
Interest income	938	-	-	938
Interest expense	(727)	-	-	(727)
Gain on interest rate derivative contract	375	-	-	375
Other income	211	-	-	211
Total other income (expense)	797	-	-	797
Income (loss) before income tax benefit	14,117	(4,219)	-	9,898
Income tax (provision) benefit	(6,638)	1,688	-	(4,950)
Net income	\$ 7,479	\$ (2,531)	\$ -	\$ 4,948
Net income per share - Basic	\$ 0.22	\$ (0.08)	\$ -	\$ 0.15
Net income per share - Diluted	\$ 0.22	\$ (0.07)	\$ -	\$ 0.14

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Weighted average shares used in  
computing net income per share:

Basic	33,520	33,520	33,520	33,520
Diluted	34,707	34,707	34,707	34,707
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**athenahealth, Inc.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited amounts in thousands, except per-share amounts)**

The following table includes selected information from our condensed consolidated statements of cash flows presenting previously reported and restated cash flows, for the nine months ended September 30, 2009:

	<b>For the Nine Months Ended September 30, 2009</b>	
	<b>As Previously Reported</b>	<b>As Restated</b>
Net income	\$ 7,479	\$ 4,948
Deferred income taxes (1)	6,109	4,421
Deferred revenue (1)	688	4,907

(1) Revenue and related tax effect due to the correction of the accounting for implementation fees.

**3. RECENT ACCOUNTING PRONOUNCEMENTS**

Effective January 1, 2010, we adopted the new accounting standards for revenue recognition for multiple deliverable revenue arrangements. This new authoritative guidance amends previously issued guidance to eliminate the residual method of allocation for multiple deliverable revenue arrangements, and requires that arrangement consideration be allocated at the inception of an arrangement to all deliverables using the relative selling price method. The new authoritative guidance also establishes a selling price hierarchy for determining the selling price of a deliverable, which includes (1) vendor-specific objective evidence ( VSOE ), if available, (2) third-party evidence ( TPE ), if vendor-specific objective evidence is not available, and (3) estimated selling price ( ESP ), if neither vendor-specific nor third party evidence is available. Additionally, it expands the disclosure requirements related to a vendor's multiple-deliverable revenue arrangements. During the second quarter of 2010 we elected to adopt early, as permitted by the guidance. As such, we have prospectively (retroactive to January 1, 2010) applied the provisions of the new authoritative guidance to all revenue arrangements entered into or materially modified after January 1, 2010. Adopting the new standard will allow the company to allocate the arrangement consideration if multiple service offerings are sold at the same time. A sale of multiple services offerings could include any combination of the following services: athenaCollector, athenaClinicals, athenaCommunicator or Business Analytics.

In accordance with the new authoritative guidance, we allocate arrangement consideration to each deliverable in an arrangement based on its relative selling price. We determine selling price using VSOE, if it exists; otherwise, we use TPE. If neither VSOE nor TPE of selling price exists for a unit of accounting, we use ESP.

VSOE is generally limited to the price charged when the same or similar product is sold separately. If a product or service is seldom sold separately, it is unlikely that we can determine VSOE for the product or service. We define VSOE as a median price of recent standalone transactions that are priced within a narrow range, as defined by us. TPE is determined based on the prices charged by our competitors for a similar deliverable when sold separately. It may be difficult for us to obtain sufficient information on competitor pricing to substantiate TPE and therefore we may not always be able to use TPE.

If we are unable to establish selling price using VSOE or TPE, and the order was received or materially modified after the implementation date of January 1, 2010 for the new authoritative guidance, we will use ESP in our allocation of arrangement consideration. The objective of ESP is to determine the price at which we would transact if the product or service were sold by us on a standalone basis. Our determination of ESP involves a weighting of several factors based on the specific facts and circumstances of the arrangement. We consider the selling price for similar services, our ongoing pricing strategy and policies, the value of any enhancements that have been built into the deliverable and the characteristics of the varying markets in which the deliverable is sold.

We plan to analyze the selling prices used in our allocation of arrangement consideration at a minimum on an annual basis. Selling prices will be analyzed on a more frequent basis if a significant change in our business necessitates a more timely analysis or if we experience significant variances in our selling prices. For athenaCommunicator, the company will use an estimated selling price when allocating the arrangement consideration



if it is sold with another deliverable.

Each deliverable within a multiple-deliverable revenue arrangement is accounted for as a separate unit of accounting under the guidance of the new authoritative guidance if both of the following criteria are met: (1) the delivered item or items have value to the customer on a standalone basis and (2) for an arrangement that includes a general right of return relative to the delivered item(s),

**athenahealth, Inc.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited amounts in thousands, except per-share amounts)**

delivery or performance of the undelivered item(s) is considered probable and substantially in our control. We consider a deliverable to have standalone value if we sell this item separately or if the item is sold by another vendor or could be resold by the customer. Further, our revenue arrangements generally do not include a general right of return relative to delivered products. Deliverables not meeting the criteria for being a separate unit of accounting are combined with a deliverable that does meet that criterion. The appropriate allocation of arrangement consideration and recognition of revenue is then determined for the combined unit of accounting.

During the nine months ended September 30, 2010, the adoption of this guidance had no material impact. The new accounting standards for revenue recognition, if applied in the same manner to the year ended December 31, 2009, would not have had a material impact on total net revenue for that fiscal year. In terms of the timing and pattern of revenue recognition, the new accounting guidance is not expected to have a significant effect on total net revenue in periods immediately after the initial adoption.

From time to time, new accounting pronouncements are issued by FASB and are adopted by us as of the specified effective date. Unless otherwise discussed, we believe that the impact of other recently issued accounting pronouncements will not have a material impact on consolidated financial position, results of operations, and cash flows, or do not apply to our operations.

**4. NET INCOME PER SHARE**

Basic net income per share is computed by dividing net income by the weighted average number of common shares outstanding during the period. Diluted net income per share is computed by dividing net income by the weighted average number of common shares outstanding and potentially dilutive securities outstanding during the period under the treasury stock method. Potentially dilutive securities include stock options, restricted stock units, shares to be purchased under the employee stock purchase plan, and warrants. Under the treasury stock method, dilutive securities are assumed to be exercised at the beginning of the periods and as if funds obtained thereby were used to purchase common stock at the average market price during the period. Securities are excluded from the computations of diluted net income per share if their effect would be antidilutive to earnings per share.

The following table reconciles the weighted average shares outstanding for basic and diluted net income per share for the periods indicated.

	Three Months Ended September 30, 2010	Three Months Ended September 30, 2009	Nine Months Ended September 30, 2010	Nine Months Ended September 30, 2009
Net income	\$ 3,826	\$ 1,166	\$ 5,401	\$ 4,948
Weighted average shares used in computing basic net income per share	34,174	33,610	34,101	33,520
Net income per share - Basic	\$ 0.11	\$ 0.03	\$ 0.16	\$ 0.15
Net income	\$ 3,826	\$ 1,166	\$ 5,401	\$ 4,948

Weighted average shares used in computing basic				
net income per share	34,174	33,610	34,101	33,520
Effect of dilutive securities	982	1,290	1,078	1,187
Weighted average shares used in computing				
diluted net income per share	35,156	34,900	35,179	34,707
Net income per share - Diluted	\$ 0.11	\$ 0.03	\$ 0.15	\$ 0.14

The computation of diluted net income per share does not include 2,927 options and restricted stock units for the three and nine months ended September 30, 2010, because their inclusion would have an antidilutive effect on net income per share. The computation of diluted net income per share does not include 1,073 options for the three and nine months ended September 30, 2009, because their inclusion would have an antidilutive effect on net income per share.

**athenahealth, Inc.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited amounts in thousands, except per-share amounts)****5. COMPREHENSIVE INCOME**

Comprehensive income was as follows for the periods indicated:

	Three Months Ended September 30, 2010	Three Months Ended September 30, 2009	Nine Months Ended September 30, 2010	Nine Months Ended September 30, 2009
Net income	\$ 3,826	\$ 1,166	\$ 5,401	\$ 4,948
Unrealized holding gain (loss) on available-for-sale investments, net of tax	28	(68)	(25)	(243)
Foreign currency translation adjustment, net of tax	32	(193)	(16)	(223)
Total comprehensive income	\$ 3,886	\$ 905	\$ 5,360	\$ 4,482

**6. FAIR VALUE OF FINANCIAL INSTRUMENTS**

As of September 30, 2010 and December 31, 2009, the carrying amounts of cash and cash equivalents, restricted cash, receivables, accounts payable, and accrued expenses approximated their estimated fair values because of their short-term nature of these financial instruments. All highly liquid debt instruments purchased with a maturity of three months or less at the date of acquisition are included in cash and cash equivalents. Included in cash and cash equivalents as of September 30, 2010 and December 31, 2009, are money market fund investments of \$7,349 and \$10,081, respectively, which are reported at fair value.

The carrying amounts of the Company's debt obligations approximate fair value based upon our best estimate of interest rates that would be available to the Company for similar debt obligations. The estimated fair value of our long-term debt was determined using quoted market prices and other inputs that were derived from available market information and may not be representative of actual values that could have been or will be realized in the future.

The following table presents information about the Company's financial assets and liabilities that are measured at fair value on a recurring basis as of September 30, 2010 and December 31, 2009, and indicates the fair value hierarchy of the valuation techniques the Company utilized to determine such fair value. In general, fair values determined by Level 1 inputs utilize quoted prices (unadjusted) in active markets for identical assets or liabilities and fair values determined by Level 2 inputs utilize quoted prices (unadjusted) in inactive markets for identical assets or liabilities obtained from readily available pricing sources for similar instruments. The fair values determined by Level 3 inputs are unobservable values which are supported by little or no market activity. Investments includes \$1,500 of Long-Term U.S. government backed securities that have been classified in other assets on the condensed consolidated balance sheet at September 30, 2010. At December 31, 2009, there were no long-term investments held by the Company.

## athenahealth, Inc.

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited amounts in thousands, except per-share amounts)

**Fair Value Measurements At September 30, 2010,****Using**

	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Total</b>
Cash equivalents:				
Money market	\$ 7,349	\$ -	\$ -	\$ 7,349
Commercial paper	-	1,002	-	1,002
U.S. government backed securities	-	2,000	-	2,000
Investments:				
Commercial paper	-	34,981	-	34,981
Corporate bonds	-	22,638	-	22,638
U.S. government backed securities	-	17,441	-	17,441
<b>Total assets</b>	<b>\$ 7,349</b>	<b>\$ 78,062</b>	<b>\$ -</b>	<b>\$ 85,411</b>
Accrued contingent consideration	\$ -	\$ -	\$ (5,404)	\$ (5,404)
Interest rate swap derivative contract	-	(766)	-	(766)
<b>Total liabilities</b>	<b>\$ -</b>	<b>\$ (766)</b>	<b>\$ (5,404)</b>	<b>\$ (6,170)</b>

**Fair Value Measurements as of December 31,****2009, Using**

	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Total</b>
Cash equivalents:				
Money market	\$ 10,081	\$ -	\$ -	\$ 10,081
Available-for-sale investments:				
U.S. government backed securities	-	52,323	-	52,323
<b>Total assets</b>	<b>\$ 10,081</b>	<b>\$ 52,323</b>	<b>\$ -</b>	<b>\$ 62,404</b>
Accrued contingent consideration	\$ -	\$ -	\$ (5,100)	\$ (5,100)
Interest rate swap derivative contract	-	(291)	-	(291)
<b>Total liabilities</b>	<b>\$ -</b>	<b>\$ (291)</b>	<b>\$ (5,100)</b>	<b>\$ (5,391)</b>

U.S. government backed securities, corporate bonds, and commercial paper are valued using a market approach based upon the quoted market prices of identical instruments when available or other observable inputs such as trading prices of identical instruments in inactive markets or similar securities. The interest rate swap derivative is valued using observable inputs at the reporting date.

It is the Company's policy to recognize transfers between levels of the fair value hierarchy, if any, at the end of the reporting period however there have been no such transfers during the nine months ended September 30, 2010.

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The fair value of the accrued contingent consideration was determined using a probability-weighted income approach at the acquisition date and reporting date. That approach is based on significant inputs that are not observable in the market, which are referred to as Level 3 inputs. Key assumptions include a discount rate of 21% and a probability adjusted level of 60%. As of September 30, 2010, the Company has accrued a liability of \$5,404 for the estimated fair value of contingent considerations expected to be payable upon the acquired company reaching specific performance metrics over the next three years of operation. As of September 30, 2010, the ranges of outcomes and key assumptions have not changed materially.

Accrued contingent consideration balance as of January 1, 2010	\$5,100
Increase in fair value of contingent consideration	304
Accrued contingent consideration balance as of September 30, 2010	\$5,404

## athenahealth, Inc.

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited amounts in thousands, except per-share amounts)

**7. INVESTMENTS**

The summary of available-for-sale securities at September 30, 2010, is as follows:

	Amortized Cost	Gross Unrealized Gain (Loss)	Fair Value
Commercial paper	\$ 34,954	\$ 27	\$ 34,981
Corporate bonds	22,652	(14)	22,638
U.S. government backed securities	17,437	4	17,441
 Total	 \$ 75,043	 \$ 17	 \$ 75,060

Investments includes \$1,500 of Long-Term U.S. government backed securities that have been classified in other assets on the condensed consolidated balance sheet at September 30, 2010. At December 31, 2009, there were no long-term investments held by the Company.

The summary of available-for-sale securities at December 31, 2009, is as follows:

	Amortized Cost	Gross Unrealized Gains	Fair Value
U.S. government backed securities	\$ 52,280	\$ 43	\$ 52,323

**8. LONG-TERM DEBT AND CAPITAL LEASE OBLIGATIONS**

The summary of outstanding debt and capital lease obligations is as follows:

	As of September 30, 2010	As of December 31, 2009
Term loan	\$ 5,400	\$ 5,625
Capital lease obligation	4,659	6,763
	10,059	12,388
Less current portion of long-term debt and capital lease obligations	(3,116)	(3,437)
Long-term debt and capital lease obligations, net of current portion	\$ 6,943	\$ 8,951

*2008 Term and Revolving Loans* On September 30, 2008, the Company entered into a credit agreement (the Credit Agreement ) with a financial institution. The Credit Agreement consists of a revolving credit facility in the amount of \$15,000 and a term loan facility in the amount of \$6,000. The revolving credit facility may be extended by an additional \$15,000 on the satisfaction of certain conditions and includes a \$10,000 sublimit for the issuance of standby letters of credit. The revolving credit facility matures on September 30, 2011, and the term facility matures on September 30, 2013, although either facility may be voluntarily prepaid in whole or in part at any time without premium or penalty. As of September 30, 2010, there were no amounts outstanding under the revolving credit facility. On September 30, 2008, the Company borrowed a total of \$6,000 under the term loan facility for general working

capital purposes. The term loan has a 5 year term which is payable quarterly starting December 31, 2008, for \$75 each quarter.

The revolving credit loan and term loan bear interest, at the Company's option, at either (i) the financial institution's London Interbank Offered Rate ( LIBOR ) or (ii) the higher of (a) the Federal Funds Rate plus 0.50% or (b) the financial institution's prime rate (the higher of the two being the Base Rate ). For term loans, these rates are adjusted down 100 basis points for Base Rate loans and up 100 basis points for LIBOR loans. For revolving credit loans, a margin is added to the chosen interest rate that is based on the Company's consolidated leverage ratio, as defined in the Credit Agreement, which margin can range from 100 to 275 basis points for LIBOR loans and from 0 to 50 basis points for Base Rate loans. A default rate shall apply on all obligations in the event of a default under the Credit Agreement at a rate per annum equal to 2% above the applicable interest rate. The Company was also required to pay commitment fees and upfront fees for this Credit Facility. The interest rate as of September 30, 2010, and December 31, 2009, for the term loan was 4.55%.

The obligations of the Company and its subsidiaries under the Credit Agreement are collateralized by substantially all assets.

The Credit Agreement also contains certain financial and nonfinancial covenants, including limitations on our consolidated leverage ratio and capital expenditures, defaults relating to non-payment, breach of covenants, inaccuracy of representations and



**athenahealth, Inc.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited amounts in thousands, except per-share amounts)**

warranties, default under other indebtedness (including a cross-default with our interest rate swap), bankruptcy and insolvency, inability to pay debtors, attachment of assets, adverse judgments, ERISA violations, invalidity of loan and collateral documents, payments of dividends, and change of control. Upon an event of default, the lenders may terminate the commitment to make loans and the obligation to extend letters of credit, declare the unpaid principal amount of all outstanding loans and interest accrued under the Credit Agreement to be immediately due and payable, require us to provide cash and deposit account collateral for our letter of credit obligations, and exercise their security interests and other rights under the Credit Agreement.

*Capital Lease Obligations* In June 2007, the Company entered into a master lease and security agreement (the Equipment Line ) with a financing company. The Equipment Line allows for the Company to lease from the financing company eligible equipment purchases, submitted within 90 days of the applicable equipment's invoice date. Each lease has a 36 month term which is payable in equal monthly installments, commencing on the first day of the fourth month after the date of the disbursements of such loan and continuing on the first day of each month thereafter until paid in full. The Company has accounted for these as capital leases. At September 30, 2010 and December 31, 2009, the Company had \$4,659 and \$6,763, respectively, of outstanding capital leases. The weighted average interest rate implicit in the leases was 4.3%.

**9. INTEREST RATE DERIVATIVE**

In October 2008, the Company entered into a derivative instrument which has a decreasing notional value over the term to offset the cash flow exposure associated with its interest payments on certain outstanding debt. Our interest rate swap is not designated as a hedging instrument. The derivative is accounted for at fair value with gains or losses reported in earnings.

The swap had a notional amount of \$5,850 to hedge changes in cash flows attributable to changes in the LIBOR rate associated with the September 30, 2008, issuance of the Term Loan due September 30, 2028. We pay a fixed rate of 4.55% and receive a variable rate based on one month LIBOR. The fair value of derivatives as of September 30, 2010, is summarized in the following table.

	Liability Derivatives Balance Sheet Location	Fair Value
Interest rate derivative contract	Interest rate derivative liability	\$ 766
Total derivative		\$ 766

The effect of derivative instruments on the consolidated statement of operations for the three months ending September 30, 2010 and 2009, respectively, is summarized in the following table.

	Location of Loss Recognized in Earnings	Loss Recognized in Earnings for Three Months Ended September 30, 2010	Loss Recognized in Earnings for Three Months Ended September 30, 2009
Interest rate contracts	Loss on interest rate derivative contract	\$ (111)	\$ (125)

The effect of derivative instruments on the consolidated statement of operations for the nine months ending September 30, 2010 and 2009, respectively, is summarized in the following table.

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	Location of (Loss) Gain Recognized in Earnings	(Loss) Recognized in Earnings for Nine Months Ended September 30, 2010	Gain Recognized in Earnings for Nine Months Ended September 30, 2009
Interest rate contracts	(Loss) gain on interest rate derivative contract	\$ (475)	\$ 375
		13	

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## athenahealth, Inc.

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited amounts in thousands, except per-share amounts)

Derivatives are carried at fair value, as determined using standard valuation models, and adjusted, when necessary, for credit risk and are separately presented on the balance sheet. The following is a description/summary of the derivative financial instrument we have entered into to manage the interest rate exposure:

Description	Underlying	Remaining		Pay	Fiscal Year Entered Into	Maturity (Fiscal Year)	Fair Value at September 30, 2010
		Notional Amount	Receive				
Interest rate swap - variable to fixed	Interest on Term Loan	\$ 5,400	LIBOR	4.55% fixed	2008	2028	\$ (766)

**10. GOODWILL**

During the three months ended September 30, 2010, the Company accrued an additional \$287 for contingent consideration of the expected earn out milestone relating to the Crest Line Technologies, LLC. (d.b.a. Medical Messaging.net) purchase. The excess purchase price over the assigned values was recorded as goodwill as this acquisition was completed prior to January 1, 2009, which was the effective date of the new authoritative guidance on business combinations. The changes in the carrying amount of goodwill for the period ended September 30, 2010 from December 31, 2009 are as follows:

Goodwill balance at December 31, 2009	\$ 22,120
Contingent consideration	287
Goodwill balance at September 30, 2010	\$ 22,407

**11. STOCK-BASED COMPENSATION***Stock Option Plan*

The following table presents the stock option activity for the nine months ended September 30, 2010:

	Shares	Weighted- Average Exercise Price	Weighted-Average Remaining Contractual Term (in years)
Stock options outstanding - January 1, 2010	3,432	\$21.62	
Stock options granted	752	\$37.11	
Stock options exercised	(338)	\$11.74	
Stock options forfeited	(206)	\$31.49	
Stock options outstanding - at September 30, 2010	3,640	\$25.18	7.5

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The Company uses the Black-Scholes option pricing model to value share-based awards and determine the related compensation expense. The assumptions used in calculating the fair value of share-based awards represent management's best estimates. The following table illustrates the weighted average assumptions used to compute stock-based compensation expense for awards granted:

	Three Months Ended September		Nine Months Ended September	
	30, 2010	2009	30, 2010	2009
Risk-free interest rate	1.7%-2.0%	2.7%-3.0%	1.7%-3.0%	1.9%-3.0%
Expected dividend yield	0.0%	0.0%	0.0%	0.0%
Expected option term (years)	6.25	6.25	6.25	6.25
Expected stock volatility	45% to 46%	49% to 50%	45% to 52%	48% to 50%

At September 30, 2010 and 2009, there was \$29,683 and \$24,165, respectively, of unrecognized stock-based compensation expense related to unvested share-based compensation stock option arrangements granted under the Company's stock award plans. This expense is expected to be recognized over a weighted-average period of approximately 2.6 years.

## athenahealth, Inc.

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited amounts in thousands, except per-share amounts)**

The weighted-average grant date fair value of options granted during the three months ended September 30, 2010, and 2009 was \$12.53 and \$16.61, respectively. The weighted-average grant date fair value of options granted during the nine months ended September 30, 2010 and 2009 was \$19.08 and \$13.13, respectively. The Company generally issues previously unissued shares for the exercise of stock options, however the Company may reissue previously acquired treasury shares to satisfy these issuances in the future. The expense to the Company for the three months ended September 30, 2010, and 2009, was \$2,949 and \$2,008, respectively. The expense to the Company for the nine months ended September 30, 2010, and 2009, was \$8,704 and \$5,797, respectively.

*Restricted Stock Units*

The 2007 Stock Option Plan also allows for granting of restricted stock unit awards under the terms of the plan. Majority of restricted units vest in four equal, annual installments on the anniversaries of the vesting start date or in four equal, quarterly installments on anniversaries of the vesting date. The Company estimated the fair value of the restricted stock units using the market price of its common stock on the date of the grant. The fair value of restricted stock units is amortized on a straight-line basis over the vesting period. The following table presents the restricted stock unit activity for the nine months ended September 30, 2010.

	Shares	Weighted-Average Grant Date Fair Value
Outstanding - January 1, 2010	-	\$0.00
Restricted stock units granted	280	\$35.43
Restricted stock units vested	-	\$0.00
Restricted stock units forfeited	(13)	\$36.78
Outstanding - at September 30, 2010	267	\$35.36

As of September 30, 2010, \$8,407 of total unrecognized compensation costs related to restricted stock units is expected to be recognized over a weighted average period of 3.4 years. This amount does not include the cost of new restricted stock units that may be granted in future periods or any changes in the Company's forfeiture percentage. Stock-based compensation expense of \$671 and \$1,451 was recorded for restricted stock units during the three and nine months ended September 30, 2010, respectively. During the three and nine months ended September 30, 2010, no restricted stock units became vested. There were no restricted stock units outstanding during the three and nine months ended September 30, 2009.

*Employee Stock Purchase Plan*

In 2007, our 2007 Employee Stock Purchase Plan ( 2007 ESPP ) was adopted by the Board of Directors and approved by the Company's shareholders. A total of 500 shares of common stock have been reserved for future issuance to participating employees under the 2007 ESPP. The expense to the Company for the three months ended September 30, 2010, and 2009, was \$142 and \$115, respectively. The expense to the Company for the nine months ended September 30, 2010, and 2009, was \$300 and \$318, respectively.

*Summary of Stock-Based Compensation Expense*

Total stock-based compensation expense for the three and nine months ended September 30, 2010 and 2009, are as follows (no amounts were capitalized):

	Three months ended September 30,		Nine months ended September 30,	
	2010	2009	2010	2009
Stock-based compensation expense charged to:				

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Direct operating	\$ 601	\$ 400	\$ 1,721	\$ 1,175
Selling and marketing	962	535	2,540	1,578
Research and development	524	255	1,527	749
General and administrative	1,674	933	4,667	2,613
Total	\$ 3,761	\$ 2,123	\$ 10,455	\$ 6,115

**12. COMMITMENTS AND CONTINGENCIES**

On March 2, 2010, a complaint was filed by *Prompt Medical Systems, L.P.* naming the Company and several other defendants in a patent infringement case (*Prompt Medical Systems, L.P. v. AllscriptsMisys Healthcare Solutions, Inc. et al*, Civil Action No. 6:2010cv00071, United States District Court for the Eastern District of Texas). The complaint alleges that we have infringed on a patent with a listed issue date in 1996 entitled *Method for Computing Current Procedural Terminology Codes from Physician*

**athenahealth, Inc.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited amounts in thousands, except per-share amounts)**

Generated Documentation and seeks an injunction enjoining infringement, damages, and pre- and post-judgment costs and interest. The Company and two other defendants filed a motion to dismiss the complaint; however, the court has not ruled on this motion. We believe that we have meritorious defenses to the complaint and continue to contest it vigorously.

On March 19, 2010, a putative shareholder class action complaint was filed in the United States District Court for the District of Massachusetts against the Company and certain of its current and former officers entitled *Casula v. athenahealth, Inc. et al*, Civil Action No. 1:10-cv-10477. On June 3, 2010, the court appointed Waterford Township General Employees Retirement System as the lead plaintiff. On August 2, 2010, the lead plaintiff filed an amended complaint. The amended complaint alleges that the defendants violated the federal securities laws by disseminating false and misleading statements through press releases, statements by senior management, and SEC filings. The alleged false and misleading statements concern, among other things, the amortization period for deferred implementation revenues. The amended complaint seeks unspecified damages, costs, and expenses. The defendants filed a motion to dismiss the amended complaint on October 1, 2010. We believe that we have meritorious defenses to the amended complaint, and we will contest the claims vigorously.

In addition, from time to time we may be subject to other legal proceedings, claims, and litigation arising in the ordinary course of business. We do not, however, currently expect that the ultimate costs to resolve any pending matter will have a material adverse effect on our consolidated financial position, results of operations, or cash flows.

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

*This Quarterly Report on Form 10-Q contains forward-looking statements. All statements other than statements of historical fact contained in this Quarterly Report on Form 10-Q are forward-looking statements, including those regarding expanded sales and marketing efforts; changes in expenses related to operations, selling, marketing, research and development, general and administrative matters, and depreciation and amortization; liquidity issues; additional fundraising; and the expected performance period and estimated term of our client relationships, as well as more general statements regarding our expectations for future financial and operational performance, product and service offerings, regulatory environment, and market trends. In some cases, you can identify forward-looking statements by terminology such as may, will, should, expects, plans, anticipates, believes, estimates, predicts, potential, or continue ; the negative of these terms; or other comparable terminology. Forward-looking statements in this Item 2 include, without limitation, statements reflecting management's expectations for future financial performance and operating expenditures, expected growth, profitability and business outlook, increased sales and marketing expenses, increased cross-selling efforts among the Company's service offerings, expected client implementations, expected certification and regulatory approvals and the benefits of the Company's current service offerings and research and development for new service offerings and the benefits of current and expected strategic and sales and marketing relationships.*

*Forward-looking statements are only current predictions and are subject to known and unknown risks, uncertainties, and other factors that may cause our actual results, levels of activity, performance, or achievements to be materially different from those anticipated by such statements. These factors include, among other things, those set forth in our Annual Report on Form 10-K for the fiscal year ended December 31, 2009, under the heading Part I, Item 1A Risk Factors and any set forth below under Part II, Item 1A, Risk Factors.*

*Although we believe that the expectations reflected in the forward-looking statements contained in this Quarterly Report on Form 10-Q are reasonable, we cannot guarantee future results, levels of activity, performance, or achievements. Except as required by law, we are under no duty to update or revise any of such forward-looking statements, whether as a result of new information, future events, or otherwise, after the date of this Quarterly Report on Form 10-Q.*

**Restatement**

With this Quarterly Report on Form 10-Q, we have restated the following previously filed consolidated financial statements, data, and related disclosures:

Our consolidated statements of operations for the three and nine months ended September 30, 2009, and the related cash flows for the nine months ended September 30, 2009 located in Part I, Item 1 of this Quarterly

(1) Report on Form 10-Q; and

Our management's discussion and analysis of financial condition and results of operations as of, and for, the

(2) three and nine months ended September 30, 2009, contained herein.

The restatement results from our review of revenue recognition practices. See Note 2, Restatement and Reclassification of Previously Issued Consolidated Financial Statements of the Notes to Condensed Consolidated Financial Statements in Part I, Item 1 for a detailed discussion of the review and effect of the restatement.

The following discussion and analysis of our financial condition and results of operations incorporates the restated amounts. For this reason the data set forth in this section may not be comparable to discussions and data in our previously filed Quarterly Reports on Form 10-Q.

**Overview**

athenahealth is a leading provider of Internet-based business services for physician practices. Our service offerings are based on four integrated components: our proprietary Internet-based software, our continually updated database of payer reimbursement process rules, our back-office service operations that perform administrative aspects of billing and clinical data management for physician practices, and our automated and live patient communication services. Our principal offering, athenaCollector, automates and manages billing-related functions for physician practices and includes a medical practice management platform. We have also developed a service offering, athenaClinicals, which automates and manages medical-record-related functions for physician practices and includes



an electronic health record, or EHR, platform. ReminderCall, which we added to our service suite in September 2008, is our automated appointment reminder system that allows patients to either confirm the appointment or request rescheduling. We have now combined ReminderCall with other automated patient messaging services, live operator services, and a patient web portal in the first edition of our athenaCommunicator services suite that we made commercially available on March 17, 2010. We refer to athenaCollector as our revenue cycle management service, athenaClinicals as our clinical cycle management service, and athenaCommunicator as our patient cycle management service. As a complement to these services, Anodyne Analytics is a web-based, Software-as-a-Service business intelligence platform that organizes and displays detailed and insightful practice performance data for decision makers at our client practices. Our services are designed to help our clients achieve faster reimbursement from payers, reduce error rates, increase collections, lower operating costs, improve operational workflow controls, improve patient satisfaction and compliance, and more efficiently manage clinical and billing information.

For the nine months ended September 30, 2010, we generated revenue of \$176.2 million from the sale of our services compared to \$134.1 million for the nine months ended September 30, 2009. For the three months ended September 30, 2010, we generated revenue of \$63.1 million from the sale of our services compared to \$47.4 million for the three months ended September 30, 2009. Given the scope of our market opportunity, we have increased our spending each year on growth, innovation, and infrastructure. Despite increased spending in these areas, higher revenue and lower operating expenses as a percentage of revenue typically lead to greater operating income.

Our revenue is predominately derived from business services that we provide on an ongoing basis. This revenue is generally determined as a percentage of payments collected by us on behalf of our clients, so the key drivers of our revenue include the number of physicians working within our client accounts, the collections of these physicians, and the number of services purchased. To provide these services, we incur expenses in several categories, including direct operating, selling and marketing, research and development, general and administrative, and depreciation and amortization expense. In general, our direct operating expense increases as our volume of work increases, whereas our selling and marketing expense increases in proportion to our rate of adding new accounts to our network of physician clients. Our other expense categories are less directly related to growth of revenues and relate more to our planning for the future, our overall business management activities, and our infrastructure. As our revenue has grown, the difference between our revenue and our direct operating expense also has grown, which has afforded us the ability to spend more in other categories of expense and to experience increases in operating income. We manage our cash and our use of credit facilities to ensure adequate liquidity, in adherence to related financial covenants.

### **Critical Accounting Policies**

The preparation of our consolidated financial statements in conformity with GAAP requires us to make estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities and the disclosures of contingent assets and liabilities as of the date of the financial statements, and the reported amounts of revenues and expenses during the reporting periods. Significant estimates and assumptions are used for, but are not limited to: (1) revenue recognition; including our estimated expected customer life; (2) allowance for doubtful accounts; (3) asset impairments; (4) depreciable lives of assets; (5) economic lives and fair value of leased assets; (6) income tax reserves and valuation allowances; (7) fair value of stock options; (8) allocation of direct and indirect cost of sales; and (9) litigation reserves. Future events and their effects cannot be predicted with certainty, and accordingly, our accounting estimates require the exercise of judgment. The accounting estimates used in the preparation of our consolidated financial statements will change as new events occur, as more experience is acquired, as additional information is obtained and as our operating environment changes. We evaluate and update our assumptions and estimates on an ongoing basis and may employ outside experts to assist in our evaluations. Actual results could differ from the estimates we have used.

Critical accounting policies are those policies that affect our more significant judgments and estimates used in the preparation of our condensed consolidated financial statements. We believe our critical accounting policies include our policies regarding revenue recognition and accounts receivable, software development costs, stock-based compensation, income taxes, goodwill and purchased intangible assets. For a more detailed discussion of our critical accounting policies, please refer to our Annual Report on Form 10-K for the fiscal year ended December 31, 2009, as filed with the Securities and Exchange Commission on March 15, 2010. For recent accounting pronouncements, please refer to Note 3.

### **Financial Operations Overview**

*Revenue.* We derive our revenue from two sources: from business services associated with our revenue cycle, clinical cycle, patient cycle and Anodyne Analytics offerings and from implementation and other services. Implementation and other revenue consists primarily of professional services fees related to assisting clients with the initial implementation of our services and for ongoing training and related support services. Business services accounted for approximately 97% of our total revenues for the nine months ended September 30, 2010 and 2009. Business services revenue is typically 2% to 8% of a practice's total collections depending upon the services purchased, the size, complexity, and other characteristics of the practice, plus a per-statement charge for billing statements that are generated for patients. Accordingly, business services revenue is largely driven by: the number of physician practices and other service providers we serve, the number of physicians and other medical providers

working in those physician practices, the volume of activity and related collections of those physicians, the mix of our services used by those physician practices and other medical providers, and our contracted rates. We expect to increase the number of physician practices we serve through increased sales and marketing expense, and we expect our existing clients to use more of our services through cross-selling efforts and growth in the number of combined services sales. There is moderate seasonality in the activity level of physician practices. Typically, discretionary use of physician services declines in the late summer and during the holiday season, which leads to a decline in collections by our physician clients about 30 to 50 days later. Additionally, the volume of activity and related collections vary from year to year based in large part on the severity, length and timing of the onset of the flu season. While we believe that the severity, length and timing of the onset of the cold and flu season will continue to impact collections by our physician clients, there can be no assurance that our future sales of these services will necessarily follow historical patterns. Implementation and other revenue is largely driven by the increase in the volume of our new business and the increase in our professional services revenue. As a result, we expect implementation and other revenue to increase in absolute terms for the foreseeable future but to remain relatively consistent as

a percentage of total revenue. None of our clients accounted for more than 10% of our total revenues for the three and nine months ended September 30, 2010, and 2009.

*Direct Operating Expense.* Direct operating expense consists primarily of salaries, benefits, claim processing costs, other direct expenses, and stock-based compensation related to personnel who provide services to clients, including staff who implement new clients. We expense implementation costs as incurred. We include in direct operating expense all service costs associated with athenaCollector, athenaClinicals, athenaCommunicator, ReminderCall, and Anodyne Analytics. Although we expect that direct operating expense will increase in absolute terms for the foreseeable future, the direct operating expense is expected to decline as a percentage of revenue over time as we increase automation. We expect to increase our overall level of automation as we become a larger operation, with higher volumes of work in particular functions, geographies, and medical specialties. We include in direct operating expense the service costs associated with our athenaClinicals offering, which includes transaction handling related to lab requisitions, lab results entry, fax classification, and other services. We also expect these expenses to increase in absolute terms for the foreseeable future but to decline as a percentage of revenue. This decrease will also be driven by increased levels of automation and economies of scale. Direct operating expense does not include allocated amounts for rent, occupancy and other indirect costs (including building maintenance and utilities), depreciation, and amortization, except for amortization related to purchased intangible assets. Amounts for rent, occupancy and other indirect costs (including building maintenance and utilities) are included in General and Administration Expenses.

*Selling and Marketing Expense.* Selling and marketing expense consists primarily of marketing programs (including trade shows, brand messaging, and on-line initiatives) and personnel-related expense for sales and marketing employees (including salaries, benefits, commissions, stock-based compensation, non-billable travel, lodging, and other out-of-pocket employee-related expenses). Although we recognize substantially all of our revenue when services have been delivered, we recognize a large portion of our sales commission expense at the time of contract signature and at the time our services commence. Accordingly, we incur a portion of our sales and marketing expense prior to the recognition of the corresponding revenue. We have increased our sales and marketing expenses from year to year and we expect to continue to increase our investment in sales and marketing by hiring additional direct sales personnel and support personnel to add new clients and increase sales to our existing clients and expanding awareness through paid search and other similar initiatives. We also plan to expand our marketing activities, such as attending trade shows, expanding user groups, and creating new printed materials. As a result, we expect that sales and marketing expense will increase in absolute terms and will likely remain at current levels as a percentage of total revenue in the near-term.

*Research and Development Expense.* Research and development expense consists primarily of personnel-related expenses for research and development employees (including salaries, benefits, stock-based compensation, non-billable travel, lodging, and other out-of-pocket employee-related expenses) and consulting fees for third-party developers. We expect that in the future, research and development expense will increase in absolute terms but not as a percentage of total revenue as new services and more mature products require incrementally less new research and development investment.

*General and Administrative Expense.* General and administrative expense consists primarily of personnel-related expense for administrative employees (including salaries, benefits, stock-based compensation, non-billable travel, lodging, and other out-of-pocket employee-related expense), occupancy and other indirect costs (including building maintenance and utilities), and insurance premiums; software license fees; outside professional fees for accountants, lawyers, and consultants; and compensation for temporary employees. We expect that general and administrative expense will increase in absolute terms as we invest in infrastructure to support our growth and as we incur additional expense related to being a publicly traded company and our restatement. Though expenses are expected to continue to rise in absolute terms, we expect general and administrative expense to decline as a percentage of total revenue over time. All amounts for rent, occupancy and other indirect costs (including building maintenance and utilities) are included in General and Administration Expenses.

*Depreciation and Amortization Expense.* Depreciation and amortization expense consists primarily of depreciation of fixed assets and amortization of capitalized software development costs, which we amortize over a

two-year period from the time of release of related software code. As we grow, we will continue to make capital investments in the infrastructure of the business and we will continue to develop software that we capitalize. At the same time, because we are spreading fixed costs over a larger client base, we expect related depreciation and amortization expense to decline as a percentage of total revenue over time.

*Other Income (Expense).* Interest expense consists primarily of interest costs related to our equipment-related term leases and our term loan and revolving loans under our credit facility, offset by interest income on investments. Interest income represents earnings from our cash, cash equivalents, and short-term investments. The gain (loss) on the interest rate derivative contract represents the change in the fair market value of a derivative instrument that is not designated as a hedge. Although this derivative has not been designated for hedge accounting, we believe that such instrument is correlated with the underlying cash flow exposure related to variability in interest rate movements on our term loan.

**Results of Operations****Comparison of the Nine Months Ended September 30, 2010 and 2009**

	Nine Months Ended September 30,		Change	
	2010	2009	Amount	Percent
Revenue:	(in thousands)			
Business services	\$ 170,051	\$ 129,933	\$ 40,118	31%
Implementation and other	6,121	4,148	1,973	48%
Total revenue	\$ 176,172	\$ 134,081	\$ 42,091	31%

*Revenue.* Total revenue for the nine months ended September 30, 2010, was \$176.2 million, an increase of \$42.1 million, or 31%, over revenue of \$134.1 million for the nine months ended September 30, 2009. This increase was due almost entirely to an increase in business services revenue.

*Business Services Revenue.* Revenue from business services for the nine months ended September 30, 2010, was \$170.1 million, an increase of 31%, over revenue of \$129.9 million for the nine months ended September 30, 2009. This increase was primarily due to the growth in the number of physicians and medical providers using our services. The number of physicians using our revenue cycle management services at September 30, 2010, was 18,573, a net increase of 3,738, or 25%, from 14,835 physicians at September 30, 2009. The number of active medical providers using our revenue cycle management services at September 30, 2010, was 26,317, a net increase of 4,217, or 19%, from 22,100 active medical providers at September 30, 2009. Also contributing to this increase was the increase in the rate of adoption of additional services into our current customer base and the growth in related collections on behalf of these physicians and medical providers. The amount of collections processed for the nine months ended September 30, 2010, was \$4.3 billion, an increase of \$0.8 billion, over posted collections of \$3.5 billion for the nine months ended September 30, 2009.

*Implementation and Other Revenue.* Revenue from implementations and other sources was \$6.1 million for the nine months ended September 30, 2010, an increase of \$2.0 million, or 48%, over revenue of \$4.1 million for the nine months ended September 30, 2009. This increase was driven by new client implementations and increased professional services for our larger client base. The number of accounts live on our revenue cycle management service, athenaCollector, at September 30, 2010, was 1,877, a net increase of 370 accounts from 1,507 accounts at September 30, 2009. The number of accounts live on our clinical cycle management service, athenaClinicals, at September 30, 2010, was 446, a net increase of 231 accounts from 215 accounts at September 30, 2009. The increase in implementation and other revenue is the result of the increase in the volume of our business.

	Nine Months Ended September 30,		Change	
	2010	2009	Amount	Percent
Direct operating costs	(in thousands)			
	\$ 72,163	\$ 57,900	\$ 14,263	25%

*Direct Operating Costs.* Direct operating expense for the nine months ended September 30, 2010, was \$72.2 million, an increase of \$14.3 million, or 25%, over costs of \$57.9 million for the nine months ended September 30, 2009. This increase was primarily due to an increase in the number of claims that we processed on behalf of our clients and the related expense of providing services, including transaction expense and employee-related costs. The amount of collections processed for the nine months ended September 30, 2010, was \$4.3 billion, an increase of \$0.8 billion, over posted collections of \$3.5 billion for the nine months ended September 30, 2009. Direct operating employee-related costs increased \$5.4 million from the nine months ended

September 30, 2009, to the nine months ended September 30, 2010. This increase is primarily due to the 21% increase in headcount since September 30, 2009. We increased the professional services headcount as part of our redesign of our client services organization and to meet the current and anticipated demand for our services as our customer base has expanded and includes larger medical groups. For the nine months ended September 30, 2010, direct operating expense includes \$1.4 million of amortization of purchased intangibles expense related to the purchase of certain assets through acquisitions completed in 2009 and 2008, compared to \$0.2 million in the nine months ended September 30, 2009. Stock-based compensation expense also increased \$0.5 million from the nine months ended September 30, 2009 to the nine months ended September 30, 2010.

	Nine Months Ended September 30,		Change	
	2010	2009	Amount	Percent
	(in thousands)			
Selling and marketing	\$ 37,986	\$ 24,850	\$ 13,136	53%
Research and development	13,543	10,368	3,175	31%
General and administrative	33,470	26,327	7,143	27%
Depreciation and amortization	7,946	5,535	2,411	44%
Total	\$ 92,945	\$ 67,080	\$ 25,865	39%

*Selling and Marketing Expense.* Selling and marketing expense for the nine months ended September 30, 2010, was \$38.0 million, an increase of \$13.1 million, or 53%, over costs of \$24.9 million for the nine months ended September 30, 2009. This increase was primarily due to an increase in stock-based compensation expense of \$1.0 million and an increase in employee-related costs and sales commission of \$7.0 million due to an increase in headcount. Our sales and marketing headcount increased by 70% since September 30, 2009, as we hired additional sales personnel to focus on adding new customers and increasing penetration within our existing markets. The increase was also due to a \$0.8 million increase in travel related expenses, a \$0.7 million increase in consulting and other software licenses, a \$2.7 million increase in online marketing, offline marketing and other marketing events, and a \$0.9 million increase in external partner commission payments.

*Research and Development Expense.* Research and development expense for the nine months ended September 30, 2010, was \$13.5 million, an increase of 31%, over research and development expense of \$10.4 million for the nine months ended September 30, 2009. This increase was primarily due to a \$2.5 million increase in employee-related costs due to an increase in headcount and an increase in stock-based compensation expense of \$0.7 million. Our research and development headcount increased 21% since September 30, 2009, as we hired additional research and development personnel in order to upgrade and extend our service offerings and develop new technologies.

*General and Administrative Expense.* General and administrative expense for the nine months ended September 30, 2010, was \$33.5 million, an increase of 27%, over general and administrative expenses of \$26.3 million for the nine months ended September 30, 2009. This increase was partially due to a \$1.3 million increase in employee-related costs due to an increase in headcount, an increase in stock-based compensation expense of \$2.1 million, a \$0.6 million increase in travel related expenses, a \$1.0 million increase in facilities related expenses, and a \$0.3 million increase in bad debt expense. Our general and administrative headcount increased by 9% since September 30, 2009, as we added personnel to support our growth. Legal, audit, insurance and consulting expenses increased \$2.2 million primarily due to \$1.8 million relating to our restatement and other additional costs of being a public company. Additionally, under new authoritative guidance on business combinations adopted January 1, 2009, any changes in the fair value of contingent consideration after the acquisition date affect earnings. The potential contingent consideration of \$7.7 million was recorded in the initial purchase price allocation at its estimated fair value of \$5.1 million. A portion of the contingent consideration relating to the Anodyne acquisition is expected to be paid in 2011 and 2012 totaling \$1.3 million is presented in other long-term liabilities. The contingent consideration will be adjusted to fair value to the amount payable when, and if, earned. The difference between the estimated and earn-out amount will be charged or credited to expense. For the nine months ended September 30, 2010, approximately \$0.3 million was expensed relating to this contingent consideration.

*Depreciation and Amortization.* Depreciation and amortization expense for the nine months ended September 30, 2010, was \$7.9 million, an increase of \$2.4 million, or 44%, over depreciation and amortization expense of \$5.5 million for the nine months ended September 30, 2009. This was primarily due to higher depreciation from fixed



asset expenditures in 2010 and 2009.

*Other Income (Expense).* Interest income for the nine months ended September 30, 2010, was \$0.2 million, a decrease of \$0.7 million from interest income of \$0.9 million for the nine months ended September 30, 2009. The decrease was directly related to the lower interest rates during 2010. Interest expense for the nine months ended September 30, 2010, and 2009 was \$0.4 million and \$0.7 million, respectively, which is driven by the balance of outstanding debt. The loss on interest rate derivative for the nine months ended September 30, 2010, was \$0.5 million, compared to a gain on interest rate derivative for the nine months ended September 30, 2009, of \$0.4 million. The gain or loss on the interest rate derivative was the result of the change in the fair market value of a derivative instrument that was not designated a hedge. Although this derivative does not qualify for hedge accounting, we believe that the instrument is closely correlated with the underlying exposure, thus managing the associated risk. The gains or losses from changes in the fair value of derivative instruments that are not accounted for as hedges are recognized in earnings.

*Income Tax Provision.* We recorded a provision for income taxes for the nine months ended September 30, 2010, of approximately \$5.1 million compared to \$5.0 million for the nine months ended September 30, 2009. We have provided income tax expense for the nine months ended September 30, 2010 and 2009, using the expected effective tax rate for the entire year of 48% and 49%, respectively.

*Comparison of the Three Months Ended September 30, 2010 and 2009*

	Three Months Ended September 30,		Change	
	2010	2009	Amount	Percent
Revenue:	(in thousands)			
Business services	\$ 61,087	\$ 45,609	\$ 15,478	34%
Implementation and other	2,056	1,796	260	14%
Total revenue	\$ 63,143	\$ 47,405	\$ 15,738	33%

*Revenue.* Total revenue for the three months ended September 30, 2010, was \$63.1 million, an increase of \$15.7 million, or 33%, over revenue of \$47.4 million for the three months ended September 30, 2009. This increase was due almost entirely to an increase in business services revenue.

*Business Services Revenue.* Revenue from business services for the three months ended September 30, 2010, was \$61.1 million, an increase of \$15.5 million, or 34%, over revenue of \$45.6 million for the three months ended September 30, 2009. The number of physicians using our revenue cycle management services at September 30, 2010, was 18,573, a net increase of 3,738, or 25%, from 14,835 physicians at September 30, 2009. The number of active medical providers using our revenue cycle management services at September 30, 2010, was 26,317, a net increase of 4,217, or 19%, from 22,100 active medical providers at September 30, 2009. Also contributing to this increase was the increase in the rate of adoption of additional services into our current customer base and the growth in related collections on behalf of these physicians and medical providers. The amount of collections processed for the three months ended September 30, 2010, was \$1.5 billion, an increase of \$0.3 billion, over posted collections of \$1.2 billion for the three months ended September 30, 2009.

*Implementation and Other Revenue.* Revenue from implementations and other sources was \$2.1 million for the three months ended September 30, 2010, an increase of \$0.3 million, or 14%, over revenue of \$1.8 million for the three months ended September 30, 2009. This increase was driven by new client implementations and increased professional services for our larger client base. The numbers of accounts live on our revenue cycle management service, athenaCollector, at September 30, 2010, was 1,877 a net increase of 370 accounts from 1,507 accounts at September 30, 2009. The number of accounts live on our clinical cycle management service, athenaClinicals, at September 30, 2010, was 446, a net increase of 231 accounts from 215 accounts at September 30, 2009. The increase in implementation and other revenue is the result of the increase in the volume of our business.

	Three Months Ended September 30,		Change	
	2010	2009	Amount	Percent
	(in thousands)			
Direct operating costs	\$ 24,543	\$ 19,942	\$ 4,601	23%

*Direct Operating Costs.* Direct operating expense for the three months ended September 30, 2010, was \$24.5 million, an increase of \$4.6 million, or 23%, over costs of \$19.9 million for the three months ended September 30, 2009. This increase was primarily due to an increase in the number of claims that we processed on behalf of our clients and the related expense of providing services, including transactions expense and employee-related costs. The amount of collections processed for the three months ended September 30, 2010, was \$1.5 billion, an increase of \$0.3 billion, over posted collections of \$1.2 billion for the three months ended September 30, 2009. Direct operating employee-related costs increased \$1.7 million from the three months ended September 30, 2009, to the three months ended September 30, 2010. This increase is primarily due to the 21% increase in headcount since September 30, 2009. We increased the professional services headcount as part of a

redesign of our client services organization and in order to meet the current and anticipated demand for our services as our customer base has expanded and includes larger medical groups. For the three months ended September 30, 2010, direct operating expense includes \$0.5 million of amortization of purchased intangibles expense related to the purchase of certain assets through acquisitions completed in 2009 and 2008 compared to \$0.1 million in the three months ended September 30, 2009. Stock-based compensation expense also increased \$0.2 million from the three months ended September 30, 2009, to the three months ended September 30, 2010.

	Nine Months Ended September 30,		Change	
	2010	2009	Amount	Percent
	(in thousands)			
Selling and marketing	\$ 13,233	\$ 8,963	\$ 4,270	48%
Research and development	4,645	3,748	897	24%
General and administrative	10,390	9,732	658	7%
Depreciation and amortization	2,869	2,098	771	37%
Total	\$ 31,137	\$ 24,541	\$ 6,596	27%

*Selling and Marketing Expense.* Selling and marketing expense for the three months ended September 30, 2010, was \$13.2 million, an increase of \$4.2 million, or 48%, over costs of \$9.0 million for the three months ended September 30, 2009. This increase was primarily due to an increase in employee-related costs and sales commission of \$2.9 million due to an increase in headcount, an increase in stock-based compensation expense of \$0.4 million, an increase in travel-related expenses of \$0.2 million, and an increase in online marketing, offline marketing and marketing events of \$0.8 million. Our sales and marketing headcount increased by 70% since September 30, 2009, as we hired additional sales personnel to focus on adding new customers and increasing penetration within our existing markets.

*Research and Development Expense.* Research and development expense for the three months ended September 30, 2010, was \$4.6 million, an increase of \$0.9 million, or 24%, over research and development expense of \$3.7 million for the three months ended September 30, 2009. This increase was primarily due to a \$0.6 million increase in employee-related costs due to an increase in headcount and an increase in stock-based compensation expense of \$0.3 million. Our research and development headcount increased 21% since September 30, 2009, as we hired additional research and development personnel in order to upgrade and extend our service offerings and develop new technologies.

*General and Administrative Expense.* General and administrative expense for the three months ended September 30, 2010, was \$10.4 million, an increase of \$0.7 million, or 7%, over general and administrative expense of \$9.7 million for the three months ended September 30, 2009. This increase was partially due to an increase in stock-based compensation expense of \$0.7 million. Additionally, legal, audit, and insurance expenses increased \$0.6 million primarily due to expenses relating to our restatement and other additional costs relating to being a public company. These increases are offset by a decrease in consulting related costs of \$0.6 million during the same period.

*Depreciation and Amortization.* Depreciation and amortization expense for the three months ended September 30, 2010, was \$2.9 million, an increase of \$0.8 million, or 37%, over depreciation and amortization expense of \$2.1 million for the three months ended September 30, 2009. This was primarily due to higher depreciation from fixed asset expenditures in 2010 and 2009.

*Other Income (Expense).* Interest income for the three months ended September 30, 2010, was less than \$0.1 million, a decrease of \$0.1 million from interest income of \$0.2 million for the three months ended September 30, 2009. The decrease was directly related to the lower interest rates during 2010. Interest expense for the three months ended September 30, 2010, and 2009 was \$0.1 million and \$0.3 million, respectively, which is driven by the balance of outstanding debt. The loss on interest rate derivative for the three months ended September 30, 2010, was \$0.1 million, compared to a loss on interest rate derivative for the three months ended September 30, 2009, of \$0.1 million. The loss on the interest rate derivative was the result of the change in the fair market value of a derivative instrument that was not designated a hedge. Although this derivative does not qualify for hedge accounting, we believe that the instrument is closely correlated with the underlying exposure, thus managing the associated risk. The gains or losses from changes in the fair value of derivative instruments that are not accounted for as hedges are

recognized in earnings.

*Income Tax Provision.* We recorded a provision for income taxes for the three months ended September 30, 2010, of approximately \$3.5 million compared to \$1.7 million for the three months ended September 30, 2009. We have provided income tax expense for the three months ended September 30, 2010 and 2009, using the expected effective tax rate for the entire year of 48% and 49%, respectively.

**Liquidity and Capital Resources**

Although we have historically funded our operations through the private and public sale of \$131.9 million in equity securities, as well as through long-term debt, working capital, and equipment-financing loans, our recent growth has been sustained by our continued profitability since the third quarter of 2007. As of September 30, 2010, our principal sources of liquidity were cash and cash equivalents and short-term investments totaling \$97.6 million. Our total indebtedness was \$10.1 million at September 30, 2010, and was comprised of capital lease obligations of \$4.7 million and a term loan of \$5.4 million.

Cash provided by operating activities during the nine months ended September 30, 2010, was \$25.3 million and consisted of net income of \$5.4 million and \$6.1 million utilized by working capital and other non-cash charges. Cash provided by operating activities

included positive non-cash adjustments of \$9.3 million related to depreciation and amortization expense, a \$10.5 million non-cash stock-based compensation expense, a \$0.3 million non-cash expense for the change in the fair value of contingent consideration, a \$0.9 million amortization of premiums on investments, a \$0.5 million non-cash loss on interest rate derivative, and \$0.6 million for a provision for uncollectible accounts. Negative non-cash adjustment related to excess tax benefit from stock-based awards of \$6.0 million and a \$2.3 million increase in deferred income taxes. Cash provided by working capital and other activities was primarily attributable to a \$6.5 million increase in deferred revenue and a \$0.8 million increase in accrued expenses offset by a \$0.4 million decrease in account payable, a \$1.0 million decrease in deferred rent, a \$4.0 million decrease in prepaid expenses and other current assets, a \$3.4 million increase in accounts receivable, and a \$0.3 million increase in other long-term assets. These changes are largely attributable to growth in the size of our business and in related direct operating expense.

Cash provided by operating activities during the nine months ended September 30, 2009, was \$21.5 million and consisted of net income of \$4.9 million and \$2.4 million utilized by working capital and other non-cash charges. Cash provided by operating activities included positive non-cash adjustments of \$5.8 million related to depreciation and amortization expense, a \$6.1 million non-cash stock-based compensation expense, a \$4.4 million decrease in deferred income taxes, and a \$0.4 million for a provision for uncollectible accounts. Negative non-cash adjustments related to amortization of discounts on investments of \$0.4 million, excess tax benefit from stock-based awards of \$1.7 million, and a \$0.4 million non-cash gain on interest rate derivative. Cash used by working capital and other activities was primarily attributable to a \$1.3 million increase in prepaid expenses and other current assets and \$4.0 million increase in accounts receivable offset by a \$3.1 million increase in accrued expenses, a \$0.8 million decrease in deferred rent, a \$0.4 million increase in accounts payable, and a \$4.9 million increase in deferred revenue. These changes are largely attributable to growth in the size of our business and in related direct operating expense.

Net cash used in investing activities was \$39.5 million for the nine months ended September 30, 2010, which consisted of purchases of short-term investments of \$102.2 million, purchases of property and equipment of \$14.1 million (including an airplane purchase of \$3.1 million), and expenditures for internal development of the athenaClinicals and athenaCommunicator applications of \$2.4 million. This is offset in part by a \$0.3 million decrease in restricted cash, \$0.3 million in proceeds from the sale and disposal of equipment, and \$78.5 million in proceeds from the sale and maturity of investments.

Net cash used in investing activities was \$23.1 million for the nine months ended September 30, 2009, which consisted of purchases of short-term investments of \$77.1 million, purchases of property and equipment of \$6.6 million, purchases of long-term investments of \$0.5 million, payments for acquisitions net of cash acquired of \$0.1 million, and expenditures for internal development of the athenaClinicals application of \$1.8 million. This is offset in part by a \$0.3 million decrease in restricted cash, \$4.7 million in proceeds from the sale and disposal of equipment, and \$58.0 million in proceeds from the sale and maturity of investments.

Net cash provided by financing activities was \$7.7 million for the nine months ended September 30, 2010. The majority of the cash provided in the period resulted from proceeds from the exercise of stock options and proceeds from our employee stock purchase plan during the period totaling \$4.4 million and excess tax benefit from stock-based awards of \$6.0 million, offset by \$2.7 million in payments on debt and capital lease obligations.

Net cash used in financing activities was \$0.4 million for the nine months ended September 30, 2009. The majority of the cash provided in the period resulted from proceeds from the exercise of stock options and proceeds from our employee stock purchase plan during the period totaling \$1.7 million and excess tax benefit from stock-based awards of \$1.7 million, offset by \$3.0 million in payments on debt and capital lease obligations.

Given our profitability over the past years and our current cash and cash equivalents, short-term investments, accounts receivable, and funds available under our existing revolving credit facility with Bank of America, N.A., we believe that we will have sufficient liquidity to fund our business and meet our contractual obligations for the foreseeable future. We may increase our capital expenditures consistent with our anticipated growth in infrastructure and personnel, and as we expand our national presence. In addition, we may pursue acquisitions or investments in complementary businesses or technologies or experience unexpected operating losses, in which case we may need to raise additional funds sooner than expected. Accordingly, we may need to engage in private or public equity or debt

financings to secure additional funds. If we raise additional funds through further issuances of equity or convertible debt securities, our existing stockholders could suffer significant dilution, and any new equity securities we issue could have rights, preferences, and privileges superior to those of holders of our common stock. Any debt financing obtained by us in the future could involve restrictive covenants relating to our capital-raising activities and other financial and operational matters, which may make it more difficult for us to obtain additional capital and to pursue business opportunities, including potential acquisitions. Beyond the twelve-month period, we intend to maintain sufficient liquidity through continued improvements in the size and profitability of our business and through prudent management of our cash resources and our credit arrangements.

We make investments in property and equipment and in software development on an ongoing basis. Our property and equipment investments consist primarily of technology infrastructure to provide capacity for expansion of our client base, including computers and related equipment in our data centers and infrastructure in our service operations. Our software development investments consist primarily of company-managed design, development, testing, and deployment of new application functionality. Because the practice management component of athenaNet is considered mature, we expense nearly all software maintenance costs for this component of our platform as incurred. For the EHR component of athenaNet, which is the platform for our athenaClinical offering, and for the

patient cycle component of athenaNet, which is the platform for our athenaCommunicator offering, we capitalize nearly all software development. In the nine months ended September 30, 2010, we capitalized \$14.1 million in property and equipment (including an airplane purchase of \$3.1 million) and \$2.4 million in software development. In the nine months ended September 30, 2009, we capitalized \$6.6 million of property and equipment and \$1.8 million of software development. We currently anticipate making aggregate capital expenditures of approximately \$17 million over the next twelve months.

### **Credit Facilities**

#### ***Term and Revolving Loans***

On September 30, 2008, we entered into a credit agreement with Bank of America, N.A. This credit agreement consists of a revolving credit facility in the amount of \$15.0 million and a term loan facility in the amount of \$6.0 million. The revolving credit facility may be extended by up to an additional \$15.0 million on the satisfaction of certain conditions and includes a \$10.0 million sublimit for the issuance of standby letters of credit. The revolving credit facility matures on September 30, 2011, and the term facility matures on September 30, 2013, although either facility may be voluntarily prepaid in whole or in part at any time without premium or penalty. On September 30, 2008, we borrowed a total of \$6.0 million under the term loan facility for general working capital purposes. As of September 30, 2010, there were no amounts outstanding under the revolving credit facility.

The revolving credit loans and term loans bear interest, at our option, at either (i) the British Bankers Association London Interbank Offered Rate (known as LIBOR), or (ii) the higher of (a) the Federal Funds Rate plus 0.50% or (b) Bank of America's prime rate. For term loans, these rates are adjusted up 100 basis points for LIBOR loans and down 100 basis points for all other loans. For revolving credit loans, a margin is added to the chosen interest rate that is based on our consolidated leverage ratio, as defined in the credit agreement, which margin can range from 100 to 275 basis points for LIBOR loans and from 0 to 50 basis points for all other loans. A default rate shall apply on all obligations in the event of a default under the credit agreement at an annual rate equal to 2% above the applicable interest rate. We were also required to pay other customary commitment fees and upfront fees for this credit facility. The interest rate as of September 30, 2010, for the term loan and for the revolving credit facility was 4.55%.

The obligations of the Company and its subsidiaries under the credit agreement are collateralized by substantially all assets.

The credit agreement also contains certain financial and nonfinancial covenants, including limitations on our consolidated leverage ratio and capital expenditures, defaults relating to non-payment, breach of covenants, inaccuracy of representations and warranties, default under other indebtedness (including a cross-default with our interest rate swap), bankruptcy and insolvency, inability to pay debtors, attachment of assets, adverse judgments, ERISA violations, invalidity of loan and collateral documents, payments of dividends, and change of control. Upon an event of default, the lenders may terminate the commitment to make loans and the obligation to extend letters of credit, declare the unpaid principal amount of all outstanding loans and interest accrued under the credit agreement to be immediately due and payable, require us to provide cash and deposit account collateral for our letter of credit obligations, and exercise their security interests and other rights under the credit agreement. As of September 30, 2010, we were in compliance with our covenants under the credit agreement.

### **Capital Leases**

As of September 30, 2010, there was a total of \$4.7 million in aggregate principal amount outstanding under a series of capital leases with one financing company. The weighted average implicit rate in the leases are 4.3% per annum, and they are payable on a monthly basis through March 2013.

### **Off-Balance Sheet Arrangements**

As of September 30, 2010, and December 31, 2009, we did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. Other than our operating leases for office space and computer equipment, we do not engage in off-balance sheet financing arrangements.

The summary of outstanding contractual obligations as of September 30, 2010, is as follows:



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	Total	Payments Due by Period				Other
		Less than 1 year	1-3 years	3-5 years	After 5 years	
Long-term debt	\$ 5,400	\$ 300	\$ 5,100	\$ -	\$ -	\$ -
Capital lease obligations	4,659	2,815	1,844	-	-	-
Operating lease obligations	27,215	5,572	10,758	9,624	1,261	-
Other	986	-	-	-	-	986
Total	\$ 38,260	\$ 8,687	\$ 17,702	\$ 9,624	\$ 1,261	\$ 986

These amounts exclude interest payments of \$0.3 million that are due in the next five years on our long-term debt.

These amounts exclude interest payments of \$1.3 million that are due in the next three years on capital lease obligations.

The commitments under our operating leases shown above consist primarily of lease payments for our Watertown, Massachusetts, corporate headquarters; our Rome, Georgia offices; our Alpharetta, Georgia offices; and our Chennai, India subsidiary location.

Other amounts consists of uncertain tax benefits relating to research and development credits. We have not utilized these credits, nor do we have an expectation of when these credits would be challenged. As of September 30, 2010, we cannot reasonably estimate when any future cash outlays would occur related to these uncertain tax positions.

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

*Foreign Currency Exchange Risk.* Our results of operations and cash flows are subject to fluctuations due to changes in the Indian rupee. None of our consolidated revenues are generated outside the United States. None of our vendor relationships, including our contracts with our offshore service providers International Business Machines Corporation and Vision Business Process Solutions, Inc., a subsidiary of Dell, Inc. (formerly Perot Systems Corporation), for work performed in India and the Philippines, is denominated in any currency other than the U.S. dollar. For the nine months ended September 30, 2010, less than 1% of our expenses occurred in our direct subsidiary in Chennai, India, and was incurred in Indian rupees. We therefore believe that the risk of a significant impact on our operating income from foreign currency fluctuations is not substantial.

*Interest Rate Sensitivity.* We had unrestricted cash, cash equivalents and short-term investments totaling \$97.6 million at September 30, 2010. These amounts are held for working capital purposes and were invested primarily in deposits, money market funds, and short-term, interest-bearing, investment-grade securities. Due to the short-term nature of these investments, we believe that we do not have any material exposure to changes in the fair value of our investment portfolio as a result of changes in interest rates. The value of these securities, however, will be subject to interest rate risk and could fall in value if interest rates rise.

*Interest Rate Risk.* As of September 30, 2010, we had long-term debt and capital lease obligations totaling \$10.1 million, which have both variable and fixed interest rate components. We have entered into an interest rate swap intended to mitigate variability in interest rate movements on our term loan. The swap has an amortizing notional amount over the swap agreement. For floating rate debt, interest rate changes generally do not affect the fair market value, but do impact future earnings and cash flows, assuming other factors are held constant.

The table below summarizes the principal terms of our interest rate swap transaction, including the notional amount of the swap, the interest rate payment we receive from and pay to our swap counterparty, the term of the transaction, and its fair market value at September 30, 2010.

Description	Underlying	Remaining		Pay	Fiscal Year Entered Into	Maturity (Fiscal Year)	Fair Value at September 30, 2010
		Notional Amount	Receive				
Interest rate swap - variable to fixed	Interest on Term Loan	\$ 5,400	LIBOR	4.55% fixed	2008	2028	\$ (766)

At September 30, 2010, there were no amounts outstanding under the revolving credit facility; however, we can draw up to \$15.0 million under this line of credit at any time. At September 30, 2010, there was \$5.4 million outstanding on the term loan. If we had drawn the total available amount, and if the prime rate thereon had fluctuated

by 10%, the interest expense would have fluctuated by approximately \$0.1 million.

**Item 4. Controls and Procedures.**

**Disclosure Controls and Procedures**

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed by us in reports we file or submit under the Securities and Exchange Act of 1934 is processed, summarized, and reported within the time periods specified in the SEC's rules and forms. As of September 30, 2010 (the Evaluation Date), our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities and Exchange Act of 1934). Our management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives, and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Our Chief Executive Officer and Chief Financial Officer have concluded based upon the evaluation described above that, as of the Evaluation Date, our disclosure controls and procedures were effective at the reasonable assurance level.

### **Changes in Internal Control Over Financial Reporting**

There have been no changes in our internal control over financial reporting for the quarter ended September 30, 2010, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## **PART II OTHER INFORMATION**

### **Item 1. Legal Proceedings.**

On March 2, 2010, a complaint was filed by *Prompt Medical Systems, L.P.* naming the Company and several other defendants in a patent infringement case (*Prompt Medical Systems, L.P. v. AllscriptsMisys Healthcare Solutions, Inc. et al*, Civil Action No. 6:2010cv00071, United States District Court for the Eastern District of Texas). The complaint alleges that we have infringed on a patent with a listed issue date in 1996 entitled *Method for Computing Current Procedural Terminology Codes from Physician Generated Documentation* and seeks an injunction enjoining infringement, damages, and pre- and post-judgment costs and interest. The Company and two other defendants filed a motion to dismiss the complaint; however, the court has not ruled on this motion. We believe that we have meritorious defenses to the complaint and continue to contest it vigorously.

On March 19, 2010, a putative shareholder class action complaint was filed in the United States District Court for the District of Massachusetts against the Company and certain of its current and former officers entitled *Casula v. athenahealth, Inc. et al*, Civil Action No. 1:10-cv-10477. On June 3, 2010, the court appointed Waterford Township General Employees Retirement System as the lead plaintiff. On August 2, 2010, the lead plaintiff filed an amended complaint. The amended complaint alleges that the defendants violated the federal securities laws by disseminating false and misleading statements through press releases, statements by senior management, and SEC filings. The alleged false and misleading statements concern, among other things, the amortization period for deferred implementation revenues. The amended complaint seeks unspecified damages, costs, and expenses. The defendants filed a motion to dismiss the amended complaint on October 1, 2010. We believe that we have meritorious defenses to the amended complaint, and we will contest the claims vigorously.

In addition, from time to time we may be subject to other legal proceedings, claims, and litigation arising in the ordinary course of business. We do not, however, currently expect that the ultimate costs to resolve any pending matter will have a material adverse effect on our consolidated financial position, results of operations, or cash flows.

### **Item 1A. Risk Factors.**

*Investing in our common stock involves a high degree of risk. You should consider carefully the risks and uncertainties described below, together with all of the other information in this filing, including the consolidated financial statements and the related notes appearing in this and other filings that we have made with the SEC, before deciding to invest in shares of our common stock. If any of the following risks actually occurs, our business, financial condition, results of operations, and future prospects could be materially and adversely affected. In that event, the market price of our common stock could decline and you could lose part or all of your investment.*

*In Item 1A ( Risk Factors ) of our Annual Report on Form 10-K for the fiscal year ended December 31, 2009, which was filed with the Securities and Exchange Commission on March 15, 2010, we describe risk factors related to the Company. The following risk factors are either new or have changed materially from those set forth in our Annual Report on Form 10-K for the year ended December 31, 2009. You should carefully review the risks involved and those described in our Annual Report on Form 10-K and in other reports we file with the Securities and Exchange Commission in evaluating our business.*

***Our operating results have in the past and may continue to fluctuate significantly, and if we fail to meet the expectations of analysts or investors, our stock price and the value of your investment could decline substantially.***

Our operating results are likely to fluctuate, and if we fail to meet or exceed the expectations of securities analysts or investors, the trading price of our common stock could decline. Moreover, our stock price may be based on expectations of our future performance that may be unrealistic or that may not be met. Some of the important factors that could cause our revenues and operating results to fluctuate from quarter to quarter include:

the extent to which our services achieve or maintain market acceptance;

our ability to introduce new services and enhancements to our existing services on a timely basis;

new competitors and the introduction of enhanced products and services from new or existing competitors;

the length of our contracting and implementation cycles;

changes in Client Days in Accounts Receivable;

the severity, length, and timing of seasonal and pandemic illnesses;

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seasonal declines in the use of physician services, generally in the late summer and during the holiday season, which lead to a decline in collections by our physician clients about 30 to 50 days later;

the financial condition of our current and potential clients;

changes in client budgets and procurement policies;

the amount and timing of our investment in research and development activities;

the amount and timing of our investment in sales and marketing activities;

technical difficulties or interruptions in our services;

our ability to hire and retain qualified personnel and maintain an adequate rate of expansion of our sales force;

changes in the regulatory environment related to healthcare;

regulatory compliance costs;

the timing, size, and integration success of potential future acquisitions; and

unforeseen legal expenses, including litigation and settlement costs.

Many of these factors are not within our control, and the occurrence of one or more of them might cause our operating results to vary widely. As such, we believe that quarter-to-quarter comparisons of our revenues and operating results may not be meaningful and should not be relied upon as an indication of future performance.

A significant portion of our operating expense is relatively fixed in nature, and planned expenditures are based in part on expectations regarding future revenue and profitability. Accordingly, unexpected revenue shortfalls, lower than expected revenue increases as a result of planned expenditures, and longer than expected impact on profitability and margins as a result of planned revenue expenditures may decrease our gross margins and profitability and could cause significant changes in our operating results from quarter to quarter. In addition, our future quarterly operating results may fluctuate and may not meet the expectations of securities analysts or investors. If this occurs, the trading price of our common stock could fall substantially either suddenly or over time.

***We may be sued by third parties for alleged infringement of their proprietary rights.***

The software and Internet industries are characterized by the existence of a large number of patents, trademarks, and copyrights and by frequent litigation based on allegations of infringement or other violations of intellectual property rights. Moreover, our business involves the systematic gathering and analysis of data about the requirements and behaviors of payers and other third parties, some or all of which may be claimed to be confidential or proprietary. We have received in the past, and may receive in the future, communications from third parties claiming that we have infringed on the intellectual property rights of others. For example, a complaint was recently filed by Prompt Medical Systems, L.P. naming us and several other defendants alleging infringement of its patent with a listed issue date in 1996 entitled *Method for Computing Current Procedural Terminology Codes from Physician Generated Documentation*. For additional information regarding this litigation, see Part II, Item I, *Legal Proceedings*. Our technologies may not be able to withstand such third-party claims of rights against their use. Any intellectual property claims, with or without merit, could be time-consuming and expensive to resolve, divert management attention from executing our business plan, and require us to pay monetary damages or enter into royalty or licensing agreements. In addition, many of our contracts contain warranties with respect to intellectual property rights, and some require us to indemnify our clients for third-party intellectual property infringement claims, which would increase the cost to us of an adverse ruling on such a claim.

Moreover, any settlement or adverse judgment resulting from such a claim could require us to pay substantial amounts of money or obtain a license to continue to use the technology or information that is the subject of the claim, or otherwise restrict or prohibit our use of the technology or information. There can be no assurance that we would be able to obtain a license on commercially reasonable terms, if at all, from third parties asserting an infringement claim; that we would be able to develop alternative technology on a timely basis, if at all; or that we would be able to obtain a license to use a suitable alternative technology to permit us to continue offering, and our clients to continue using, our affected services. Accordingly, an adverse determination could prevent us from offering our services to others. In addition, we may be required to indemnify our clients for third-party intellectual property infringement claims, which would increase the cost to us of an adverse ruling for such a claim.

***Current and future litigation against us could be costly and time-consuming to defend.***

We may from time to time be subject to legal proceedings and claims that arise in the ordinary course of business, such as claims brought by our clients in connection with commercial disputes and employment claims made by our current or former employees. Claims may also be asserted by or on behalf of a variety of other parties, including patients of our physician clients, government agencies, or stockholders. For example, on March 19, 2010, a putative shareholder class action complaint was filed against us and certain of our current and former officers in the United States District Court for the District of Massachusetts alleging violation of the

federal securities laws by dissemination of false and misleading statements. For additional information regarding this litigation, see Part II, Item I, Legal Proceedings.

Any litigation involving us may result in substantial costs and may divert management's attention and resources, which may seriously harm our business, overall financial condition, and operating results. Insurance may not cover existing or future claims, be sufficient to fully compensate us for one or more of such claims, or continue to be available on terms acceptable to us. A claim brought against us that is uninsured or underinsured could result in unanticipated costs, thereby reducing our operating results and leading analysts or potential investors to reduce their expectations of our performance resulting in a reduction in the trading price of our stock.

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

Not applicable.

**Item 3. Defaults Upon Senior Securities.**

Not applicable.

**Item 4. (Removed and Reserved).**

**Item 5. Other Information.**

Not applicable.

**Item 6. Exhibits.**

(a) Exhibits.

No.	Exhibit Index
10.1*	Employment Agreement by and between the Registrant and Daniel H. Orenstein, dated July 1, 2010.
10.2*	Employment Agreement by and between the Registrant and Ed Park, dated July 1, 2010.
31.1*	Rule 13a-14(a) or 15d-14 Certification of Chief Executive Officer
31.2*	Rule 13a-14(a) or 15d-14 Certification of Chief Financial Officer
32.1*	Certifications of Chief Executive Officer and Chief Financial Officer pursuant to Exchange Act rules 13a-14(b) or 15d-14(b) and 18 U.S.C. Section 1350
101.INS**	XBRL Instance Document.
101.SCH**	XBRL Schema Document.
101.CAL**	XBRL Calculation Linkbase Document.
101.LAB**	XBRL Labels Linkbase Document.
101.PRE**	XBRL Presentation Linkbase Document.

Indicates a management contract or any compensatory plan, contract, or arrangement.

\* Filed herewith

\*\* Extensible Business Reporting Language (XBRL) information is furnished and deemed not filed or a part of a registration statement or prospectus for purposes of sections 11 or 12 of the Securities Act of 1933, is deemed not filed for purposes of section 18 of the Securities Exchange Act of 1934, and otherwise is not subject to liability under these sections.



**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 thereunto duly authorized.

ATHENAHEALTH, INC.

By: /s/ Jonathan Bush  
Jonathan Bush  
Chief Executive Officer, President, and  
Chairman

By: /s/ Timothy M. Adams  
Timothy M. Adams,  
Chief Financial Officer, Senior Vice President,  
and Treasurer

Date: October 22, 2010