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2009 Annual Report

About Healthways (NASDAQ: HWAY)

Healthways is the leading provider of specialized, comprehensive solutions to help millions of people maintain or improve their health and well-being and, as a result, reduce overall costs. Healthways' solutions are designed to **keep healthy people healthy, mitigate or eliminate lifestyle risk factors that can lead to disease and optimize care for those with chronic illness.**

Our proven, evidence-based programs provide highly specific and personalized interventions for each individual in a population, irrespective of age or health status, and are delivered to consumers by phone, mail, internet and face-to-face interactions, both domestically and internationally. Healthways also provides a national, fully accredited complementary and alternative Health Provider Network and a national Fitness Center Network, offering convenient access to individuals who seek health services outside of, and in conjunction with, the traditional healthcare system. For more information, **please visit www.healthways.com.**

Financial Highlights

Year Ended and at December 31, (In thousands, except per share data)	2009	2008 (unaudited)
Operating Data		
Revenues	**$ 717,426**	$ 746,704
Net income	**$ 10,374**	$ 39,063
Diluted earnings per share	**$ 0.30**	$ 1.10
Adjusted diluted earnings per share[1]	**$ 1.04**	$ 1.57
Diluted weighted average common shares and equivalents	**34,359**	35,508
Operating Statistics		
Billed lives	**36,000**	32,900
Financial Position		
Cash and cash equivalents	**$ 2,356**	$ 5,157
Working capital (deficit)	**(44,296)**	(6,034)
Total assets	**882,366**	883,090
Long-term debt	**254,345**	304,372
Other long-term liabilities	**42,615**	39,533
Stockholders' equity	**377,277**	357,036

(1) See page 62 for a reconciliation of GAAP and non-GAAP results.

Fellow Shareholders:

Healthway's operating and financial performance for 2009 was very encouraging relative to our outlook at the start of the year. Despite the severe economic downturn, rapidly rising unemployment and other headwinds, we managed to offset attrition and maintained or increased billed lives sequentially for each quarter of the year. We renewed each of the four significant contracts that were up for renewal in 2009. After a substantial decline for the first quarter, our comparable-quarter RFPs stabilized for the remainder of the year, even as we received a material increase in unsolicited calls from existing or potential customers. Achieving a major strategic priority, we launched our WholeHealth solution through the signing of a contract with a *Fortune* 100 company. Despite the start-up of our third international contract, through which we entered Australia, our third continent beyond the U.S., we brought our international business to break-even performance for the fourth quarter.

As a result, despite falling from levels achieved for 2008, our consolidated revenue exceeded our original guidance for 2009 and our adjusted net income per diluted share was at the top of our guidance range. Our substantial profits for the year contributed to record cash flows, which funded both key capital expenditures as we continued to invest in our future and significant debt reduction. We completed 2009 with a stronger financial position than we had at the beginning of the year, and our financial outlook for 2010 is also improved over our original outlook for the year past. Healthways performed well in a tough environment for 2009 – in its existing contracts, in its business development and in its management of daily operations – even as we laid the foundation for future growth with new contracts, customers, capabilities and infrastructure.

Our financial results for 2009 included total revenues of $717.4 million compared with $746.7 million for the year ended December 31, 2008. Net income for 2009 was $10.4 million, or $0.30 per diluted share, compared with $39.1 million, or $1.10 per diluted share, for the year ended December 31, 2008. Excluding lawsuit settlement costs of $0.73, adjusted net income per diluted share for 2009 was $1.04 compared with $1.57 per diluted share, excluding costs of $0.47 related to our restructuring initiative and stock option tender offer, for the year ended December 31, 2008.

The Company's net cash flows from operations for 2009 were a record $113 million, despite lawsuit settlement costs of $40 million. After capital expenditures of $49 million for the year, we still reduced our total debt outstanding by $50 million. This debt reduction combined with solid profitability lowered the ratio of long-term debt to total capitalization at the end of 2009 by 570 basis points to 40.5% from 46.2% at December 31, 2008. The ratio of long-term debt to EBITDA as calculated under our credit agreement was 1.9 at the end of 2009, better than our forecast for the year.

As we look to 2010, we remain cautious due to the continued uncertainty over the strength of the economy and near double-digit unemployment, but we expect to produce margin improvement and increased per-share earnings. Our guidance for 2010 revenue is in a range of $677 million to $717 million, and consistent with our guidance for 2009, the lower end of this revenue guidance assumes no new unsigned business and no organic growth in billed lives. Our guidance for 2010 net income per diluted share is in a range of $1.05 to $1.18. We again expect to fund planned capital expenditures, which for 2010 are anticipated within a range of $45 million to $50 million, with net cash flows from operations, which are forecast in a range of $80 million to $100 million. We intend to continue applying free cash flow primarily to the reduction of debt.

Despite our near-term caution, we expect a number of industry trends and Healthways initiatives to support our earnings growth during 2010 and beyond.

Increasing market interest in prevention and wellness. Nearly 80% of our RFPs for 2009 required wellness and prevention services, either stand alone or integrated with chronic care services. We also experienced substantial growth in our SilverSneakers® Fitness Program and entered our first major contract to make our fitness network available to millions of individuals in an existing customer's commercial population. As anticipated, health care reform focused increasing attention on the demand side of the health care demand/supply equation by increasing access to wellness, prevention and health promotion services.

Successful introduction of expanded value proposition. The signing of our first WholeHealth contract, with a *Fortune* 100 company, successfully introduced an order-of-magnitude increase in our value proposition. Through this contract, we expect to deliver measurable and sustained improvements in health and well-being, while lowering medical costs and improving health-related productivity. We expect the success of this solution will provide Healthways a significant competitive advantage. We believe we stand alone in our ability to respond to employers' demands for a healthier, more productive and less costly workforce, which is critical to their corporate performance.

Continuing demand for greater integration. During 2009, approximately one-third of our RFPs were related to integrated services covering wellness, prevention and chronic care. An increasing number of RFPs also focus on our ability to accomplish varying degrees of data integration. The substantial interest generated by the announcement of our first WholeHealth contract, which represents a new standard of comprehensive, integrated services and data management, substantiates our expectation that this trend will strengthen over time. That expectation is further supported by the recent extension and expansion of our contract with Blue Cross Blue Shield of Massachusetts to provide our full suite of total population management services for their approximately 2 million members. This agreement provides evidence that our solution and data integration capabilities are not just of interest to employers, but are resonating with our health plan customers and prospects as well.

Increased ability to sustain engagement of individuals. Healthways continued to enhance its long-term position as the industry's leader in multi-behavior change solutions through the acquisition of HealthHonors. This acquisition provides Healthways a unique, scientific basis for sustaining behavior change through highly individualized incentives that are both more effective and lower in cost.

International performance and expansion. Our development work in countries around the world validates the potential we see for significant long-term growth in our international business. From this work, we know that the focus on improving health outcomes and addressing escalating healthcare costs is as intense internationally as it is domestically.

As you will read in the following pages, Healthways remains at the industry's forefront in expanding our skills, infrastructure, and reach in a nearly 30-year mission to improve health and reduce costs for millions of people around the world. Our goal is ever closer, as is evident both by the successful 2009 launch of our next generation technology platform, Embrace, which is designed to support delivery of all our solutions and in particular our integrated well-being improvement solutions like WholeHealth, and by the recent announcement of our exclusive strategic relationship with Blue Zones™ to create, support and sustain a national movement to improve community health and well-being.

In closing, we thank our colleagues for their passionate commitment to improving people's health and well-being, and for the hard work that daily translates this passion into better outcomes. We also thank you, our fellow shareholder, for your investment in Healthways and the support it has provided in an economic environment more challenging than any this Company has previously experienced. Despite this environment, we produced tangible accomplishments in 2009 that are changing the basic language that our existing and potential customers are using to describe their needs. We are confident of our ability to execute on the opportunities before us to drive growth in earnings and long-term shareholder value.

Sincerely,

Ben R. Leedle, Jr.
Chief Executive Officer

Redefining Health as Well-Being

Traditional approach measures health as simply 'lack of disease or infirmity'

Our solutions are based upon a much broader view of health– 'a state of complete physical, emotional and social well-being'

Healthways' purpose is to create a healthier world, one person at a time. Far from an empty slogan, our purpose is the organizing principle for the Company and drives our ceaseless efforts to broaden and deepen the capacity of our solutions to accomplish that goal. As our solutions have grown ever more comprehensive over the years, our simple value proposition – healthier people cost less – and our demonstrated ability to deliver on it repeatedly, has increasingly resonated with employers, health organizations and governments around the world. While the approximately 36 million individuals engaged in our programs at the end of 2009 make us the industry leader, we still, literally, have a world of opportunity before us.

Throughout most of Healthways' history, we primarily focused on helping people with chronic disease and other health conditions to improve their clinical outcomes and, thereby, reduce medical costs. While our results consistently achieve those objectives, the degree of savings produced for our customers has been increasingly overwhelmed by the combined effect of rapid annual increases in the number of new people becoming ill, the cost of their care and the overall cost of care itself. In pursuit of our purpose and to remain relevant to our customers, we concluded several years ago that we must expand our value proposition to solutions that not only optimize health for those with chronic illness, but also prevent, delay or mitigate the onset of disease in the first place.

As a result of that insight, and recognizing the exponential increase in opportunity it encompasses, we broadened our definition of "health" to that of the World Health Organization (WHO): "… **a state of complete physical, mental and social well-being, and not merely the absence of disease or infirmity.**" We also expanded from our historic focus on disease management solutions and began our transition to becoming the industry-leading well-being improvement company.

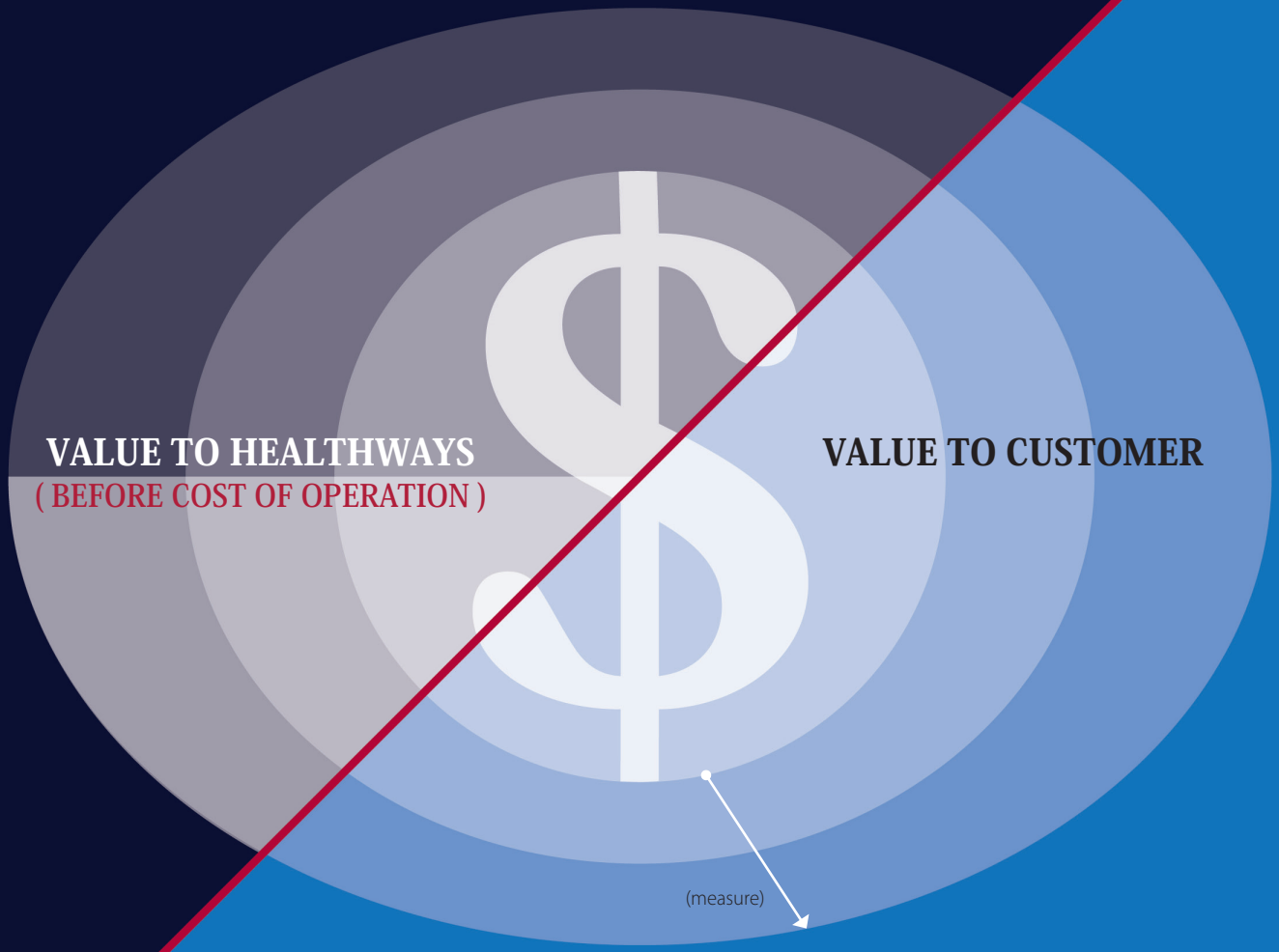
Based on nearly 30 years of providing disease specific solutions, we are confident that the most powerful value proposition for driving improved well-being derives from the accomplishment of three aims – keeping healthy people healthy, mitigating or eliminating lifestyle risk factors that can lead to disease and optimizing care for those with chronic illness. However, to be paid for delivering this value proposition, we have to be able to measure the economic value in every unit of well-being improvement and the quantity of well-being improvement achieved. In short, since we are paid only for performance, we must be able to prove our performance to our customers with clear outcomes analyses based on application of the soundest methodologies available.

Measuring Well-Being and Economic Value through the WBI

When we adopted the WHO definition of health, we knew that neither the science nor the data were available to benchmark well-being or to measure the value of improved well-being. Concurrently, Gallup was developing increased interest in the potential of the well-being construct. Joining forces more than three years ago, we brought the world's leading experts together to create the Gallup-Healthways Well-Being Index™ (WBI), which we expect to become the world's recognized standard for measuring well-being. Nearing a million completed surveys to-date, the WBI is already the largest psychometric and behavioral economics database on health in existence, and will grow by at least 1,000 completed surveys per day in America for more than the next two decades.

The WBI is a unique and proprietary instrument of significant power and potential. The insights on well-being it has provided for states, congressional districts, communities and countries have garnered tremendous attention nationally and worldwide. As the data pool deepens, we expect to drill down to the zip code level with increasing sensitivity.

Healthier People
Cost Less and Perform Better



Value Creation • Value Share • Value Expansion

Innovate → Perform → Prove

To bring the power of the WBI's insights to the most exacting possible level – the individual – we have created a unique Well-Being Assessment (WBA), which combines the questions from the WBI with standard Health Risk Assessment (HRA) questions, enabling significantly improved scalability due to lower cost, web-based technology. The results from the WBA are instrumental in allowing us to develop a personalized well-being improvement plan for each individual we serve. The value of these capabilities contributed to the signing of our first WholeHealth contract – with a *Fortune* 100 company – in the third quarter of 2009. This agreement is the first integrated, comprehensive solution for improving well-being at the employer level. Our solution for this customer incorporates the WBA both to baseline the employer's population and to measure value created over time through improved health and well-being, reduced medical expense and improved health-related productivity.

We are only just beginning to tap the WBI's potential power. As the sensitivity of the data becomes more refined, we expect our ability to determine cause and effect will also increase. Eventually we expect to refine our insights to know exactly what things an individual must do to increase well-being, the degree of change expected from each element of the solution and the time required for each element to actually achieve positive change at both the individual and organizational or community level. In addition, as our measurement capabilities become more precise, so too will the precision with which we can prove the economic value creation in which we will share.

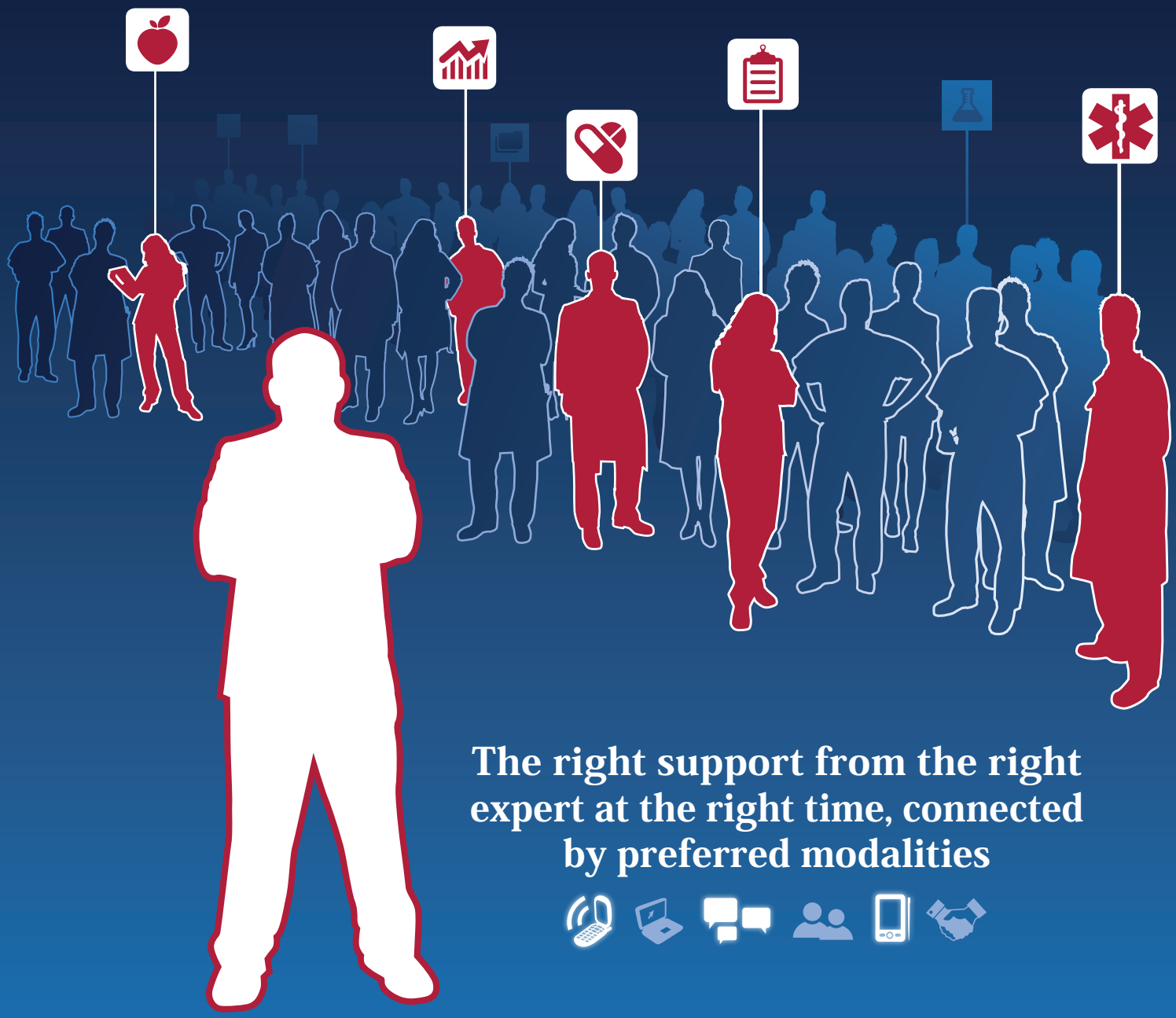
Implementing the Operational Framework for Improved Well-Being by Integrating the Power of Individuals, Experts and Communities

In our 2007 Annual Report, we discussed our proprietary simulation model designed to demonstrate the potential savings per employee from providing our WholeHealth program to a given employer population. If, in a perfect state, we achieved 100% well-being optimization, the model projected savings per employee of $13,400 annually in the fifth year following implementation. Of this total, $6,000 in value accrued to the employee and his or her family and community. The remaining $7,400 represented cost savings for the employer, with $5,400 produced by increased productivity and $2,000 by a reduction in direct medical cost. At that time, our fully optimized capabilities, which were still only focused on improving the physical health component of well-being, would have produced approximately 12% of the potential employer savings, or about $900 per individual.

Today, as reflected in the launch of our WholeHealth solution, we have successfully developed and brought to market the solution through which we can drive productivity savings and earn an appropriate share of the economic value they represent. In addition, through the establishment of our recently announced Healthways-Blue Zones Vitality Quest℠ initiative – designed to create, support and sustain a national movement to improve community health and well-being – we are introducing a vehicle through which we can create – and earn a share of – the value that improved well-being accrues for the individual, his or her family and the community.

As a result, we believe we now have designed an operational framework through which we can address and leverage the power of individuals, experts and communities to drive improved well-being, supported by and integrated with our direct interventions. While we will continue to innovate to create greater value within this framework, we believe it is through this framework that we can scale the delivery of our value proposition to include not just health plans and employers, but also communities, cities, states and even countries.

Personalized Support



The right support from the right expert at the right time, connected by preferred modalities

Everything starts with the individual

Our mission to create a healthier world, one person at a time, was not developed by chance. Through long experience, we know that the variables influencing what works best for each individual are so numerous and diverse that the only way to optimize health and health savings is to engage each individual on a personalized basis. We refer to this process as mass customization, and our colleagues, solutions, technologies, science and infrastructure are focused on helping the individual make the right choices to improve well-being.

Fundamental to our process is the creation of a Well-Being prescription for each individual, which addresses that person's health status and unique needs. As with any prescription, we work with each individual to determine the frequency of intervention, its intensity and the duration necessary to achieve the desire result. We also determine the modality of intervention that each individual prefers, such as one-on-one in person, face-to-face in groups, out-bound or in-bound telephone, or electronic, including text, chat, e-mail, video on-line, remote monitoring, smart phone, or an increasing array of social media. Further, since any prescription only addresses needs at a certain point in time, we update the prescription and the preference set it encompasses on a regular and as-needed basis.

People need expert support because they're human

We continuously engage with each individual because both our experience and the scientific literature reflects that at least nine out of ten people need help and reinforcement to make the countless daily choices that affect their health. While we bring tremendous support to individuals through our direct interaction, we also support their interactions with a variety of experts – medical and otherwise – some of whom we bring to the relationship.

When people inevitably need help from traditional medical experts – a doctor, nurse, pharmacist, hospital, laboratory or other diagnostic facility – we support those relationships by making access, communication and data exchange better, faster, less expensive and more consistent. In addition, the information we gather from those interactions enables us to update the individual's Well-Being prescription and add our support to the plan put in place by the medical expert.

In seeking help with their health, as opposed to their health care, many people look outside the traditional medical community to a wide variety of experts, such as nutritionists, massage therapists, chiropractors, acupuncturists, exercise specialists, trainers and life coaches. Not only do we support these relationships just as we do those in the medical community but, in many cases, we are also responsible for bringing these experts to the relationship. Our national, fully accredited complementary and alternative Health Provider Network has about 37,000 of these experts and our national Fitness Center Network can be accessed in approximately 15,000 certified locations. Our SilverSneakers® Fitness Program is but one example of how we are integrating experts into our solutions, as well as providing these experts the curriculum, training and programs designed to advance the individual's well-being, in a manner consistent with the individual's preference set.

The Home Radius

30 mi.

0 mi.

30 mi.

*Most people spend about **80%** of their time within **30 miles** of their home.*

HOME
HEALTH EXPERT
FITNESS CENTER
RETAIL
WORK
MEDICAL EXPERT
SPIRITUAL
SCHOOL

The power of community

We know through the science of behavior change that medical and health experts are often not the people who have the most influence in determining the choices an individual makes related to well-being. A person's home life plays a major role, as each individual is influenced by family and friends. Work environment also has a tremendous influence, since people in the workforce spend more than 50% of their waking hours on the job. Studies show that most people spend about 80% of their time within 30 miles of their home. The physical environment, the social norms and the policies and regulations that contribute to the cultural environment of this "home radius" – in other words, their community - also affect their well-being and can have either a positive or negative impact on healthy behaviors and lifestyle choices.

Because we understand that it takes a team of experts to drive meaningful and measurable improvement in well-being across these settings, and because of the importance of community to that effort, we recently joined with Blue Zones to establish Healthways-Blue Zones Vitality Quest℠. Vitality Quest is designed to align the interests of community leaders – in government, business, education, nonprofits and other influential organizations – to create a community in which people are healthier and happier, live longer, are more vital and productive, and enjoy an improved standard of living… a community whose citizens enjoy measurably higher well-being and lower healthcare costs. Higher well-being for a community's citizens also yields competitive advantage for economic development and job creation. For employers, it means greater productivity, engagement and improved health for their workforce and dependent families, resulting in better business performance. For individuals, it means living well, longer.

Our partner in Vitality Quest brings intellectual property, a strong brand and recognized science to this initiative. Its successful AARP-Blue Zones pilot in Albert Lea, MN, implemented large- and small-scale environmental and policy changes to encourage residents to adopt and maintain healthier lifestyles, while developing the social, commercial, communal and professional networks needed to support them. With 27% of the population participating, there was an average weight loss across the entire population of Albert Lea of two pounds per person, an increase in the average life expectancy of 3.1 years and a 20% reduction in absenteeism for key employers. Over half the community's employers were actively engaged in the pilot, 60% of the city's restaurants and 100% of its schools. Complementing Blue Zone's strengths, we expect that Healthways' proven ability to drive and measure improved well-being, our technology infrastructure, our human and financial resources and our experience developed through serving millions of people will enable us to scale the delivery of our value proposition through Vitality Quest to serve more and larger cities.

As we look forward, we are confident that our increasing understanding of the drivers of well-being for individuals, organizations, communities and countries, coupled with the expansion of our value proposition, creates substantial long-term growth opportunities for Healthways and provides meaningful first-to-market competitive advantage. We are confident of successfully executing against our well-being improvement framework, while continuing to innovate within it to enhance our ability to improve well-being and increase operating efficiencies. As a result, we believe **Healthways is uniquely positioned to produce long-term value for our customers, the communities and countries in which we operate and, therefore, our Company, employees and shareholders.**

Selected Financial Data

(In thousands, except per share data)

	Year Ended December 31, 2009 [1] [2]	Four Months Ended December 31, 2008 [1] [2]	Year Ended August 31, 2008 [1] [2]	2007 [1] [2]	2006 [1]	2005
Operating Results:						
Revenues	$ **717,426**	$ 244,737	$ 736,243	$ 615,586	$ 412,308	$ 312,504
Cost of services (exclusive of depreciation and amortization included below)	**522,999**	177,651	503,940	417,721	281,161	205,253
Selling, general and administrative expenses	**71,535**	27,790	71,342	67,352	44,417	28,418
Depreciation and amortization	**49,289**	16,188	47,479	37,044	24,517	22,408
Impairment loss	**—**	4,344	—	—	—	—
Restructuring and related charges	**—**	10,264	—	—	—	—
Operating income	**73,603**	8,500	113,482	93,469	62,213	56,425
Gain on sale of investment	**(2,581)**	—	—	—	—	—
Interest expense	**15,717**	6,757	20,927	18,185	1,053	1,630
Legal settlement and related costs	**39,956**	—	—	—	—	—
Income before income taxes	**20,511**	1,743	92,555	75,284	61,160	54,795
Income tax expense	**10,137**	1,009	37,741	30,163	24,009	21,711
Net income	$ **10,374**	$ 734	$ 54,814	$ 45,121	$ 37,151	$ 33,084
Basic income per share: [1]	$ **0.31**	$ 0.02	$ 1.57	$ 1.29	$ 1.08	$ 1.00
Diluted income per share: [1]	$ **0.30**	$ 0.02	$ 1.50	$ 1.22	$ 1.02	$ 0.93
Weighted average common shares and equivalents:						
Basic	**33,730**	33,616	34,977	35,049	34,348	33,241
Diluted	**34,359**	34,038	36,597	37,002	36,379	35,691
Balance Sheet Data:						
Cash and cash equivalents	$ **2,356**	$ 5,157	$ 35,242	$ 47,655	$ 154,792	$ 63,467
Working capital (deficit)	**(44,296)**	(6,034)	21,276	10,792	124,469	70,644
Total assets	**882,366**	883,090	906,813	828,845	382,386	270,954
Long-term debt	**254,345**	304,372	345,395	297,059	236	416
Other long-term liabilities	**42,615**	39,533	31,227	14,388	10,853	9,055
Stockholders' equity	**377,277**	357,036	354,334	362,750	274,873	206,930
Other Operating Data:						
Billed lives	**36,000**	32,900	31,700	27,400	2,426	1,883
Annualized revenue in backlog	$ **32,400**	$ 35,900	$ 13,600	$ 39,900	$ 6,625	$ 32,578

(1) Includes $13.9 million, $14.7 million, $18.1 million, $21.0 million, and $15.3 million during fiscal 2009, the four months ended December 31, 2008, and fiscal 2008, 2007, and 2006, respectively, of costs related to equity-based awards expensed under accounting principles generally accepted in the United States of America ("U.S. GAAP") and cash-based awards issued in lieu of equity-based awards that were historically granted to certain levels of management. These cash-based awards are a result of changes in the design of the Company's long-term incentive compensation program in preparation for adopting a new accounting pronouncement governing stock-based compensation on September 1, 2005.

(2) Includes operating results, balance sheet data, and other operating data of Axia Health Management, Inc. since the date of the acquisition, which was December 1, 2006.

Management's Discussion and Analysis of Financial Condition and Results of Operation

Overview

Founded in 1981, Healthways, Inc. provides specialized, comprehensive solutions to help people improve physical, emotional and social well-being, reducing both direct healthcare costs and costs associated with the loss of health-related employee productivity.

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

In North America, our customers include health plans, governments, employers, pharmacy benefit managers, and hospitals in all 50 states, the District of Columbia and Puerto Rico. We also provide health improvement programs and services in Germany, Brazil and Australia. We operate care enhancement and coaching centers worldwide staffed with licensed health professionals. Our fitness center network encompasses more than 15,000 U.S. locations. We also maintain an extensive network of over 37,000 complementary and alternative medicine and chiropractic practitioners, which offers convenient access to the significant number of individuals who seek health services outside of the traditional healthcare system.

Our guiding philosophy and approach to market is predicated on the fundamental belief that healthier people cost less and are more productive. As described more fully below, our programs are designed to help keep healthy individuals healthy, mitigate and delay the progression to disease associated with lifestyle risk factors, and optimize care for those who are already affected by health conditions or disease.

First, our programs are designed to help keep healthy people healthy by:

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

Our prevention programs focus on education, physical fitness, health coaching, behavior change techniques and support, and evidence-based interventions to drive adherence to proven standards of care, medication regimens and physicians' plans of care. We believe this approach optimizes the health status of member populations and reduces the short- and long-term direct healthcare costs for participants, including costs associated with the loss of health-related employee productivity.

Second, our programs are designed to drive healthy behaviors and mitigate lifestyle risk by:

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

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

Finally, our programs are designed to optimize care for those with existing conditions or disease by:

- incorporating the latest, evidence-based clinical guidelines into interventions to optimize patient health outcomes;
- developing care support plans and motivating members to set attainable goals for themselves;
- providing local market resources to address acute episodic interventions;

- coordinating members' care with their healthcare providers;
- providing software licensing and management consulting in support of well-being improvement services; and
- providing high-risk care management for members at risk for hospitalization due to complex conditions.

Our approach is to use proprietary, analytic models to identify individuals who are likely to incur future high costs without intervention, including those who have specific gaps in care that can be addressed to reduce disease progression and medical spending.

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

Change in Fiscal Year

In August 2008, our Board of Directors approved a change in our fiscal year-end from August 31 to December 31. Accordingly, our 2009 fiscal year began on January 1, 2009 following a four-month transition period ended December 31, 2008. References herein to fiscal 2009 refer to the year ended December 31, 2009; references herein to fiscal 2008 and fiscal 2007 refer to the years ended August 31, 2008 and 2007, respectively.

Forward-Looking Statements

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

- our ability to sign and implement new contracts for our solutions;
- our ability to retain existing customers and to renew or maintain contracts with our customers under existing terms or restructure these contracts on terms that would not have a material negative impact on our results of operations;
- our ability to accurately forecast performance and the timing of revenue recognition under the terms of our customer contracts ahead of data collection and reconciliation in order to provide forward-looking guidance;
- the impact of national healthcare reform proposals and the potential impact of healthcare reform legislation, if enacted, on our operations and/or the demand for our services;
- the impact of any new or proposed legislation, regulations and interpretations relating to the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, including the potential expansion to Phase II for Medicare Health Support programs and any legislative or regulatory changes with respect to Medicare Advantage;
- our ability to reach mutual agreement with the Centers for Medicare & Medicaid Services ("CMS") with respect to results under Phase I of Medicare Health Support;
- our ability to anticipate the rate of market acceptance of our solutions in potential international markets;
- our ability to accurately forecast the costs necessary to implement our strategy of establishing a presence in international markets;
- the risks associated with foreign currency exchange rate fluctuations and our ability to hedge against such fluctuations;

- the risks associated with a significant concentration of our revenues with a limited number of customers;
- our ability to effect cost savings and clinical outcomes improvements under our contracts and reach mutual agreement with customers with respect to cost savings, or to effect such savings and improvements within the time frames contemplated by us;
- our ability to achieve estimated annualized revenue in backlog in the manner and within the time frame we expect, which is based on certain estimates regarding the implementation of our services;
- our ability and/or the ability of our customers to enroll participants in our programs in a manner and within the time frame anticipated by us;
- the ability of our customers to provide timely and accurate data that is essential to the operation and measurement of our performance under the terms of our contracts;
- our ability to favorably resolve contract billing and interpretation issues with our customers;
- our ability to service our debt and make principal and interest payments as those payments become due;
- the risks associated with changes in macroeconomic conditions, which may reduce the demand and/or the timing of purchases for our services from customers or potential customers, reduce the number of covered lives of our existing customers, restrict our ability to obtain additional financing, or impact the availability of credit under our Third Amended Credit Agreement;
- counterparty risk associated with our interest rate swap agreements and foreign currency exchange contracts;
- our ability to integrate acquired businesses or technologies into our business;
- the impact of any impairment of our goodwill or other intangible assets;
- our ability to develop new products and deliver outcomes on those products;
- our ability to implement our new integrated data and technology solutions platform within the time frame and cost estimates that we expect;
- our ability to obtain adequate financing to provide the capital that may be necessary to support our operations and to support or guarantee our performance under new contracts;
- unusual and unforeseen patterns of healthcare utilization by individuals with diabetes, cardiac, respiratory and/or other diseases or conditions for which we provide services;
- the ability of our customers to maintain the number of covered lives enrolled in the plans during the terms of our agreements;
- the impact of litigation involving us and/or our subsidiaries;
- the impact of future state, federal, and international healthcare and other applicable legislation and regulations on our ability to deliver our services and on the financial health of our customers and their willingness to purchase our services;
- current geopolitical turmoil, the continuing threat of domestic or international terrorism, and the potential emergence of a health pandemic; and
- other risks detailed in this Annual Report on Form 10-K, including those set forth in Item 1A.

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

Critical Accounting Policies

We describe our accounting policies in Note 1 of the Notes to the Consolidated Financial Statements. We prepare the consolidated financial statements in conformity with U.S. GAAP, which requires us to make estimates and judgments that

affect the reported amounts of assets and liabilities and related disclosures at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results may differ from those estimates.

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

Revenue Recognition

We generally determine our contract fees by multiplying a contractually negotiated rate per member per month ("PMPM") by the number of members covered by our services during the month. We typically set the PMPM rates during contract negotiations with customers based on the value we expect our programs to create and a sharing of that value between the customer and the Company. In addition, some of our services, such as the SilverSneakers fitness program, are billed on a fee for service basis.

Our contracts with health plans generally range from three to five years with provisions for subsequent renewal; contracts with self-insured employers, either directly or through their health plans or pharmacy benefit manager, typically have one to three-year terms. Some of our contracts allow the customer to terminate early.

Some of our contracts provide that a portion (up to 100%) of our fees may be refundable to the customer ("performance-based") if our programs do not achieve, when compared to a baseline year, a targeted percentage reduction in the customer's healthcare costs and selected clinical and/or other criteria that focus on improving the health of the members. Approximately 4% of revenues recorded during fiscal 2009 were performance-based and were subject to final reconciliation as of December 31, 2009. We anticipate that this percentage will fluctuate due to the level of performance-based fees in new contracts and the timing and amount of revenue recognition associated with performance-based fees. Some contracts also provide opportunities for us to receive incentive bonuses in excess of the contractual PMPM rate if we exceed contractual performance targets.

We generally bill our customers each month for the entire amount of the fees contractually due for the prior month's enrollment, which typically includes the amount, if any, that is performance-based and may be subject to refund should we not meet performance targets. Deferred revenues arise from contracts which permit up front billing and collection of fees covering the entire contractual service period, generally 12 months. Contractually, we cannot bill for any incentive bonus until after contract settlement. Fees for service are typically billed in the month after the services are provided.

We recognize revenue as follows: 1) we recognize the fixed portion of PMPM fees and fees for service as revenue during the period we perform our services; 2) we recognize the performance-based portion of the monthly fees based on the most recent assessment of our performance, which represents the amount that the customer would legally be obligated to pay if the contract were terminated as of the latest balance sheet date; and 3) we recognize additional incentive bonuses based on the most recent assessment of our performance, to the extent we consider such amounts collectible.

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

In 2005, we began participating in two Medicare Health Support pilots, which concluded in January 2008 and July 2008, respectively. Substantially all of the fees under these pilots were performance-based. Our original cooperative agreements required that, by the end of the third year, we achieve a cumulative net savings (total savings for the intervention population as compared to the control group less fees received from CMS) of 5.0%. Under an amendment to our agreement for our stand-alone Medicare Health Support pilot in Maryland and the District of Columbia, we began serving a "refresh population" of approximately 4,500 beneficiaries on August 1, 2006, which was measured as a separate cohort

for two years, by the end of which the program was required to achieve a 2.5% cumulative net savings when compared to a new control cohort. In April 2008, we signed an amendment to our Medicare Health Support protocol with CMS, which changed the financial performance target for both the initial and the refresh populations to budget neutrality. In late April 2009, we received the final reconciliation report from CMS' independent financial reconciliation contractor. Based upon this final reconciliation report as well as our performance over the term of the pilots, we have recognized $9.5 million of cumulative performance-based fees related to these pilots and $12.2 million of fixed fees. At December 31, 2009, approximately $57.8 million of performance-based fees related to these pilots was recorded in contract billings in excess of earned revenue, $50.3 million of which related to fees collected, and the remaining $7.5 million of which related to fees billed but not collected due to CMS withholding payment of these fees. We submitted our objections to the final reconciliation report and engaged in discussions with CMS regarding our objections. We, along with several other participating organizations in the Medicare Health Support pilots, have submitted a proposal to CMS to resolve the issues related to the reconciliation; however, such proposal remains subject to approval by the United States government.

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

During the settlement process under a contract, which generally occurs six to eight months after the end of a contract year, we settle any performance-based fees and reconcile healthcare claims and clinical data. As of December 31, 2009, performance-based fees that have not yet been settled with our customers but that have been recognized as revenue in the current and prior years totaled approximately $46.4 million, all of which was based on actual data received from our customers. Data reconciliation differences, for which we provide contractual allowances until we reach agreement with respect to identified issues, can arise between the customer and us due to customer data deficiencies, omissions, and/or data discrepancies.

Performance-related adjustments (including any amounts recorded as revenue that were ultimately refunded), changes in estimates, data reconciliation differences, or adjustments to incentive bonuses may cause us to recognize or reverse revenue in a current fiscal year that pertains to services provided during a prior fiscal year. During fiscal 2009, we recognized a net increase in revenue of $8.6 million that related to services provided prior to fiscal 2009.

Impairment of Intangible Assets and Goodwill

We review goodwill for impairment on an annual basis (during the fourth quarter of our fiscal year) or more frequently whenever events or circumstances indicate that the carrying value may not be recoverable.

We completed an annual goodwill impairment test as of June 30, 2009 and concluded that no impairment of goodwill exists. Due to the recent change in our fiscal year-end from August 31 to December 31, the date of our annual impairment test changed to October 31 beginning on October 31, 2009. We completed an annual goodwill impairment test as of October 31, 2009 and concluded that no impairment of goodwill exists.

We estimate the fair value of each reporting unit using a discounted cash flow model and reconcile the aggregate fair value of our reporting units to our consolidated market capitalization. The discounted cash flow model requires significant judgments, including management's estimate of future cash flows, which is dependent on internal forecasts, estimation of the long-term growth rate for our business, the useful life over which cash flows will occur, and determination of our weighted average cost of capital. Changes in these estimates and assumptions could materially affect the estimate of fair value and goodwill impairment for each reporting unit.

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

Except for a trade name which has an indefinite life and is not subject to amortization, we amortize identifiable intangible assets, such as acquired technologies and customer contracts, using the straight-line method over their estimated useful lives. We assess the potential impairment of intangible assets subject to amortization whenever events or changes in circumstances indicate that the carrying values may not be recoverable.

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

If we determine that the carrying value of other identifiable intangible assets may not be recoverable, we calculate any impairment using an estimate of the asset's fair value based on the estimated price that would be received to sell the asset in an orderly transaction between market participants.

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

Income Taxes

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

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

Share-Based Compensation

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

Business Strategy

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

Our business strategy reflects our passion to enhance health and well-being, and as a result, reduce overall costs and improve workforce engagement, yielding better business performance for our customers. Our programs are designed to:

- keep healthy individuals healthy;
- mitigate and delay the progression of disease associated with lifestyle risk factors; and
- optimize care for those who are already affected by health conditions or disease.

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

We believe it is critical to impact an entire population's underlying health status and well-being in a long-term, cost effective way. Believing that what gets measured gets acted upon, in January 2008, we entered into an exclusive, 25-year relationship with Gallup to provide a national, daily pulse of individual and collective well-being. The Gallup-Healthways Well-Being Index™ is a unique partnership in well-being measurement and research that is based on surveys of 1,000 Americans every day, seven days a week. Under the agreement, Gallup evaluates and reports on the well-being of individuals of countries, states and communities; Healthways provides similar services for companies, families and individuals.

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

We are adding and enhancing solutions to extend our reach and effectiveness and to meet increasing demand for integrated solutions. The flexibility of our programs allows customers to provide those services they deem appropriate for their organizations. Customers may select from certain single program options up to a total-population approach, in which all members of a customer's population are eligible to receive benefits.

Our strategy includes as a priority the ongoing development of an order-of-magnitude increase in our value proposition through introducing our WholeHealth solution. This solution, in addition to improving health and reducing direct healthcare costs, targets a much larger impact on employer profitability by lowering the costs of lost productivity due to health-related reasons. With the success of our WholeHealth solution, we expect to gain a significant competitive advantage in responding to employers' needs for a healthier, higher-performing and less costly workforce.

Our strategy also includes the further enhancement of our proprietary next generation technology platform known as Embrace. This platform, which is essential to our WholeHealth solution, enables us to integrate data from all the healthcare entities interacting with an individual. Embrace enables the delivery of our integrated solutions and ongoing communications between the individual and his/her medical and health experts, using any method desired, including venue-based face-to-face; print; phone; mobile and remote devices; on-line; emerging modalities; and any combination thereof.

We plan to increase our competitive advantage in delivering our services by leveraging our scalable, state-of-the-art call centers, medical information content, behavior change processes and techniques, strategic relationships, health provider networks, fitness center relationships, and proprietary technologies and techniques. We anticipate we will continue to enhance, expand and further integrate capabilities, pursue opportunities in domestic government and international markets, and enhance our information technology support. We may add some of these new capabilities and technologies through internal development, strategic alliances with other entities and/or through selective acquisitions or investments.

Results of Operations

The following table shows the components of the statements of operations for the fiscal year ended December 31, 2009, the four months ended December 31, 2008 and 2007, and the fiscal years ended August 31, 2008 and 2007 expressed as a percentage of revenues.

	Year Ended December 31, 2009	Four Months Ended December 31, 2008	Four Months Ended December 31, 2007	Year Ended August 31, 2008	Year Ended August 31, 2007
Revenues	**100.0 %**	100.0 %	100.0 %	100.0 %	100.0 %
Cost of services (exclusive of depreciation and amortization included below)	**72.9 %**	72.6 %	69.9 %	68.4 %	67.9 %
Selling, general and administrative expenses	**10.0 %**	11.4 %	9.3 %	9.7 %	10.9 %
Depreciation and amortization	**6.9 %**	6.6 %	5.8 %	6.4 %	6.0 %
Impairment loss	**—**	1.8 %	—	—	—
Restructuring and related charges	**—**	4.2 %	—	—	—
Operating income (1)	**10.3 %**	3.5 %	15.0 %	15.4 %	15.2 %
Gain on sale of investment	**(0.4) %**	—	—	—	—
Interest expense	**2.2 %**	2.8 %	3.0 %	2.8 %	3.0 %
Legal settlement	**5.6 %**	—	—	—	—
Income before income taxes	**2.9 %**	0.7 %	11.9 %	12.6 %	12.2 %
Income tax expense	**1.4 %**	0.4 %	4.9 %	5.1 %	4.9 %
Net income (1)	**1.4 %**	0.3 %	7.0 %	7.4 %	7.3 %

(1) Figures may not add due to rounding.

Revenues

Revenues for fiscal 2009 decreased $18.8 million, or 2.6%, over fiscal 2008, primarily due to the following:

- contract restructurings and terminations with certain customers; and
- decreased revenues related to our Medicare Health Support pilots, which ended in January and July 2008, respectively.

These decreases were somewhat offset by increases in revenues primarily due to the following:

- the commencement of contracts with new customers;
- increased revenues from fitness center programs, primarily due to an increase in participation in these programs as well as in the number of members eligible for them;
- growth in the number of self-insured employer lives under existing customer contracts;
- increased performance-based revenues due to our ability to measure and achieve performance targets on certain contracts during fiscal 2009; and
- increased membership in customers' existing programs.

Revenues for the four months ended December 31, 2008 increased $10.5 million, or 4.5%, over revenues for the four months ended December 31, 2007, primarily due to the following:

- the commencement of new contracts;

- growth in the number of self-insured employers on behalf of our health plan customers; and
- the addition of new programs or the expansion of existing programs into additional populations with existing customers.

These increases were partially offset by decreases in revenues primarily due to contract restructurings and terminations with certain customers, program terminations by certain customers, and the loss by some of our health plan customers of their administrative services only ("ASO") employer accounts.

Revenues for fiscal 2008 increased $120.7 million, or 19.6%, over fiscal 2007 primarily due to the acquisition of Axia on December 1, 2006. The remainder of the increase is primarily due to the following:

- the addition of new customers, new programs with existing customers, or the expansion of existing programs into additional populations with existing customers since the beginning of fiscal 2007; and
- increased membership in customers' existing programs.

These increases were partially offset by decreases in revenues related to contract terminations and restructurings with certain customers.

Cost of Services

Cost of services (excluding depreciation and amortization) as a percentage of revenues for fiscal 2009 increased to 72.9% compared to 68.4% for fiscal 2008, primarily due to the following:

- an increased portion of our revenue generated by fitness center and certain health improvement programs, which typically have a higher cost of services as a percentage of revenue than our other programs;
- the addition of certain participating locations to our fitness center network that have a higher cost of services as a percentage of revenue;
- contract restructurings with certain customers that resulted in either decreased revenues or lower per member fees without a proportional corresponding decrease in costs; and
- an increase in the level of employee bonus provision based on the Company's financial performance against established internal targets during these periods.

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

- a decrease in salaries and benefits expense, primarily due to a restructuring of the Company that was largely completed during the fourth calendar quarter of 2008 and a decrease in health insurance costs related to changes in employee medical plan design in fiscal 2009, which included a number of wellness initiatives aimed at improving employee health; and
- cost savings related to certain cost management initiatives.

During the three months ended December 31, 2009, there were no material changes in cost of services (excluding depreciation and amortization) as a percentage of revenues from previous quarters during 2009, except for a decrease in the level of employee bonus provision based on the Company's year-to-date financial performance against established internal targets.

Cost of services (excluding depreciation and amortization) as a percentage of revenues increased to 72.6% for the four months ended December 31, 2008 compared to 69.9% for the four months ended December 31, 2007, primarily due to the following:

- the completion of an offer to purchase from our employees, excluding the chief executive officer and Board of Directors, outstanding options to acquire shares of common stock of the Company that were granted between September 1, 2004 and August 15, 2008 under our shareholder-approved stock option plans (the "Tender Offer") on December 30, 2008. The Tender Offer resulted in additional stock-based compensation expense

within cost of services of $7.4 million, representing the remaining compensation cost for these options as measured at the grant date but not yet recognized prior to the completion of the Tender Offer;

- increased member utilization of fitness centers for contracts for which we receive a fixed fee per member;
- contract restructurings with certain customers, as noted above, that resulted in decreased revenues without a proportional corresponding decrease in costs; and
- increased costs related to information technology hosting security and storage for the four months ended December 31, 2008.

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

- decreased costs related to the two Medicare Health Support pilots in which we participated, which ended in January 2008 and July 2008, respectively; and
- cost savings related to certain cost management initiatives.

Cost of services (excluding depreciation and amortization) as a percentage of revenues for fiscal 2008 increased to 68.4% compared to 67.9% for fiscal 2007, primarily due to the following:

- an increased portion of our revenue growth generated by fitness center programs, which typically have a higher cost of services as a percentage of revenue than our other programs; and
- an increase in the level of employee bonus provision during fiscal 2008 compared to fiscal 2007 based on the Company's financial performance against established internal targets during these periods.

These increases were partially offset by a decrease in cost of services as a percentage of revenues due to decreased costs during fiscal 2008 related to the two Medicare Health Support pilots in which we participated, which ended in January 2008 and July 2008, respectively.

Selling, General and Administrative Expenses

Selling, general and administrative expenses as a percentage of revenues increased to 10.0% for fiscal 2009 compared to 9.7% for fiscal 2008, primarily due to the following:

- a net increase in salaries and benefits expense, primarily due to the Company restructuring in the fourth calendar quarter of 2008, which included an increased focus on research and development activities, resulting in an increase in personnel dedicated to these activities that more than offset the reduction in head count resulting from this restructuring and other workforce reductions; and
- an increase in the level of employee bonus provision based on the Company's financial performance against established internal targets during these periods.

These increases were partially offset by a decrease in professional consulting fees primarily related to product innovation and strategic and organizational design initiatives in fiscal 2008.

Selling, general and administrative expenses as a percentage of revenues increased to 11.4% for the four months ended December 31, 2008 compared to 9.3% for the four months ended December 31, 2007, primarily due to the completion of the Tender Offer on December 30, 2008, which resulted in additional stock-based compensation expense within selling, general and administrative expenses of $4.1 million, representing the remaining compensation cost for these options as measured at the grant date but not yet recognized prior to the completion of the Tender Offer.

Selling, general and administrative expenses as a percentage of revenues decreased to 9.7% for fiscal 2008 compared to 10.9% for fiscal 2007, primarily due to the following:

- efficiencies from the integration of the Axia acquisition; and
- our ability to more effectively leverage our selling, general and administrative expenses as a result of growth in our operations.

These decreases were somewhat offset by an increase in selling, general and administrative expenses as a percentage of revenues for fiscal 2008 compared to fiscal 2007 related to relocating to and operating our new corporate headquarters during fiscal 2008.

Depreciation and Amortization

Depreciation and amortization expense increased 3.8% for fiscal 2009 compared to fiscal 2008, primarily due to increased depreciation expense resulting from capital expenditures of computer software, which we made to enhance our information technology capabilities, somewhat offset by a decrease in amortization expense related to certain intangible assets that became fully amortized in September 2008.

Depreciation and amortization expense increased 18.3% for the four months ended December 31, 2008 compared to the four months ended December 31, 2007, primarily due to increased depreciation expense resulting from capital expenditures of computer software and hardware, which we made to enhance our information technology capabilities, and capital expenditures related to our new corporate headquarters. This increase was partially offset by a decrease in amortization expense related to certain intangible assets that became fully amortized in September 2008.

Depreciation and amortization expense increased 28.2% for fiscal 2008 compared to fiscal 2007, primarily due to the following:

- increased depreciation expense resulting from capital expenditures on computer software development, which we made to enhance our information technology capabilities;
- depreciation and amortization expense associated with the depreciable assets and identifiable intangible assets recorded in connection with the Axia acquisition on December 1, 2006; and
- increased amortization expense associated with patents which were acquired in August 2007.

Restructuring and Related Charges and Impairment Loss

During the four months ended December 31, 2008, we incurred net charges of $10.3 million related to a restructuring of the Company announced in October 2008, which primarily consisted of severance costs, net of equity forfeitures, and costs associated with capacity consolidation.

In December 2008, we decided to discontinue offering one of our products as a standalone program. As a result of this decision we did not renew the expiring trade name associated with this product and recorded an impairment loss of $4.3 million during the four months ended December 31, 2008 to write off this intangible asset.

Gain on Sale of Investment

In January 2009, a private company in which we held preferred stock was acquired by a third party. As part of this sale, we received two payments totaling $11.6 million in January and February 2009 and recorded a gain of $2.6 million during the first quarter of 2009.

Interest Expense

Interest expense for fiscal 2009 decreased $5.2 million compared to fiscal 2008, primarily as a result of a decrease in floating interest rates on outstanding borrowings under the Third Amended Credit Agreement during fiscal 2009 compared to fiscal 2008.

Interest expense for the four months ended December 31, 2008 decreased $0.4 million compared to the four months ended December 31, 2007, primarily as a result of a decrease in interest rates on outstanding borrowings somewhat offset by a higher average level of outstanding borrowings under the Third Amended Credit Agreement during the four months ended December 31, 2008 compared to the four months ended December 31, 2007.

Interest expense for fiscal 2008 increased $2.7 million compared to fiscal 2007, primarily related to increased interest expense during the three months ended November 30, 2007 compared to the three months ended November 30, 2006 due to borrowings under the Third Amended Credit Agreement related to the acquisition of Axia on December 1, 2006. This increase was somewhat offset by a decrease in interest expense from lower average interest rates during fiscal 2008 compared to fiscal 2007.

Legal Settlement and Related Costs

In March 2009, our Board of Directors approved a settlement of a qui tam lawsuit filed in 1994 on behalf of the United States government related to the Company's former Diabetes Treatment Center of America business. As a result of the settlement, which was effective as of April 1, 2009, we incurred a charge of approximately $40 million, including a $28 million payment to the United States government and payment of approximately $12 million for other costs and fees related to the settlement, including the estimated legal costs and expenses of the plaintiff's attorneys.

Income Tax Expense

Our effective tax rate increased to 49.4% for fiscal 2009 compared to 40.8% for fiscal 2008, primarily due to a relatively small base of pretax income for fiscal 2009 in relation to both the lack of tax benefit on certain expenses incurred in international initiatives and certain non-deductible expenses. The differences between the statutory federal income tax rate of 35.0% and our effective tax rate are due primarily to the impact of state income taxes, the lack of tax benefit on certain expenses incurred in international initiatives, and certain non-deductible expenses for income tax purposes.

Our effective tax rate increased to 57.9% for the four months ended December 31, 2008 compared to 41.1% for the four months ended December 31, 2007, primarily due to a relatively small base of pretax income for the four months ended December 31, 2008 in relation to the lack of tax benefit on certain expenses incurred in international initiatives, the impact of tax interest accruals, and the impact of certain non-deductible expenses for income tax purposes.

Our effective tax rate increased to 40.8% for fiscal 2008 compared to 40.1% for fiscal 2007, primarily due to the impact of interest accruals related to unrecognized tax benefits included in our income tax provision for fiscal 2008. The differences between the statutory federal income tax rate of 35.0% and our effective tax rate are due primarily to the impact of state income taxes, the lack of tax benefit on certain expenses incurred in international initiatives, the tax interest accruals described above, and certain non-deductible expenses for income tax purposes.

Outlook

We anticipate that revenues for fiscal 2010 will likely decrease slightly compared to fiscal 2009 primarily due to contract restructurings and terminations with certain customers, program terminations by certain customers, and the loss by some of our health plan customers of their ASO employer accounts, which will likely more than offset increases in revenue from higher fitness center participation and from new or existing customers.

Notwithstanding the anticipated decrease in revenues in fiscal 2010, we expect cost of services and selling, general and administrative expenses as a percentage of revenues for fiscal 2010 to decrease compared to fiscal 2009 due to continuing operational efficiencies. We anticipate depreciation and amortization expense for fiscal 2010 to increase over fiscal 2009, primarily due to amortization of capitalized software costs related to our new integrated data and technology solutions platform.

As discussed in "Liquidity and Capital Resources" below, a significant portion of our long-term debt is subject to fixed interest rate swap agreements; however, we cannot predict the potential for changes in interest rates, which would impact our variable rate debt, especially in light of current economic conditions that have created uncertainty and credit constraints in the markets. We anticipate that our effective tax rate for fiscal 2010 will decrease to a level consistent with that incurred during fiscal 2008; however, we continue to evaluate the impact on our effective tax rate of both international operations and any future adjustments related to uncertain tax positions.

Liquidity and Capital Resources

Operating activities for the year ended December 31, 2009 generated cash of $112.9 million compared to $105.3 million for the year ended August 31, 2008. The increase in operating cash flow resulted primarily from the following:

- a decrease in income tax payments during fiscal 2009 primarily related to a smaller base of pretax income in fiscal 2009;
- an increase in cash collections on accounts receivable for fiscal 2009 compared to fiscal 2008 due to the timing of cash receipts as well as an improvement in days' sales outstanding; and
- a decrease in interest payments during fiscal 2009, primarily as a result of a decrease in floating interest rates on outstanding borrowings under the Third Amended Credit Agreement.

These increases were somewhat offset by decreases in operating cash flow primarily related to the following:

- payments during fiscal 2009 related to the aforementioned legal settlement and related costs and fees;
- payments during fiscal 2009 related to a restructuring of the Company that was largely completed during the fourth quarter of calendar 2008, which primarily consisted of severance costs and costs associated with capacity consolidation; and
- a higher amount of lease incentives received during fiscal 2008 compared to fiscal 2009, primarily related to our new corporate headquarters in fiscal 2008.

Investing activities during fiscal 2009 used $62.4 million in cash, which primarily consisted of costs associated with software development, purchases of property and equipment associated with relocating one of our regional offices, and business acquisitions and investments, slightly offset by proceeds from the sale of an investment, described above.

Financing activities during fiscal 2009 used $53.4 million in cash primarily due to net payments on borrowings under the Third Amended Credit Agreement.

On December 1, 2006, we entered into the Third Amended Credit Agreement. The Third Amended Credit Agreement provides us with a $400.0 million revolving credit facility, including a swingline sub facility of $10.0 million and a $75.0 million sub facility for letters of credit, a $200.0 million term loan facility, and an uncommitted incremental accordion facility of $200.0 million. As of December 31, 2009, availability under our revolving credit facility totaled $147.7 million.

Revolving advances under the Third Amended Credit Agreement generally bear interest, at our option, at 1) LIBOR plus a spread of 0.875% to 1.750% or 2) the greater of the federal funds rate plus 0.5%, or the prime rate, plus a spread of 0.000% to 0.250%. Term loan borrowings bear interest, at our option, at 1) LIBOR plus 1.50% or 2) the greater of the federal funds rate plus 0.5%, or the prime rate. The Third Amended Credit Agreement also provides for a fee ranging between 0.150% and 0.300% of unused commitments. The Third Amended Credit Agreement is secured by guarantees from most of the Company's domestic subsidiaries and by security interests in substantially all of the Company's and such subsidiaries' assets.

We are required to repay outstanding revolving loans on the revolving commitment termination date, which is December 1, 2011. We are required to repay term loans in quarterly principal installments aggregating $0.5 million each, which commenced on March 31, 2007, and the entire unpaid principal balance of the term loans is due and payable at maturity on December 1, 2013.

The Third Amended Credit Agreement contains various financial covenants, which require us to maintain, as defined, ratios or levels of 1) total funded debt to EBITDA, 2) fixed charge coverage, and 3) net worth. In connection with the legal settlement described above, in March 2009 we entered into a sixth amendment to the Third Amended Credit Agreement to expressly exclude up to $40 million of expenses attributable to this settlement from the calculation of earnings before interest, taxes, depreciation and amortization, or EBITDA, for purposes of covenant calculations. The Third Amended

Credit Agreement also restricts the payment of dividends and limits the amount of repurchases of the Company's common stock. As of December 31, 2009, we were in compliance with all of the covenant requirements of the Third Amended Credit Agreement.

As of December 31, 2009, we are a party to the following interest rate swap agreements for which we receive a variable rate of interest based on LIBOR and for which we pay the following fixed rates of interest plus a spread of 0.875% to 1.750% on revolving advances and a spread of 1.50% on term loan borrowings:

Swap #	Original Notional Amount (in $000s)	Fixed Interest Rate	Termination Date	
1	$ 184,000	4.995 %	March 31, 2010	(1)
2	46,000	4.995 %	March 31, 2010	(2)
3	40,000	3.433 %	December 30, 2011	
4	50,000	3.688 %	December 30, 2011	
5	40,000	3.855 %	December 30, 2011	(3)
6	30,000	3.760 %	March 30, 2011	(4)
7	57,500	3.385 %	December 31, 2013	(5)
8	57,500	3.375 %	December 31, 2013	(6)

(1) The principal value of this swap agreement amortizes over a 39-month period. During the three months ended December 31, 2009, the notional amount of this swap was $16 million.
(2) The principal value of this swap agreement amortizes over a 39-month period. During the three months ended December 31, 2009, the notional amount of this swap was $4 million.
(3) This swap agreement became effective October 1, 2009.
(4) This swap agreement became effective January 2, 2010.
(5) This swap agreement becomes effective January 1, 2012. The principal value of this swap agreement will amortize over a 24-month period.
(6) This swap agreement becomes effective January 3, 2012. The principal value of this swap agreement will amortize over a 24-month period.

We currently meet the hedge accounting criteria under U.S. GAAP in accounting for these interest rate swap agreements.

We believe that cash flows from operating activities, our available cash, and our expected available credit under the Third Amended Credit Agreement will continue to enable us to meet our contractual obligations and to fund our current operations for the foreseeable future. However, if our operations require significant additional financing resources, such as capital expenditures for technology improvements, additional call centers and/or letters of credit or other forms of financial assurance to guarantee our performance under the terms of new contracts, or if we are required to refund performance-based fees pursuant to contract terms, we may need to raise additional capital by expanding our existing credit facility and/or issuing debt or equity. If we face a limited ability to arrange such financing, it may restrict our ability to effectively operate our business. Current economic conditions, including turmoil and uncertainty in the financial services industry, have created constraints on liquidity and the ability of some entities to obtain credit from banks or in the capital markets. We cannot assure you that we would always be able to secure additional financing if needed and, if such funds were available, whether the terms or conditions would be acceptable to us.

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

Contractual Obligations

The following schedule summarizes our contractual cash obligations by the indicated period as of December 31, 2009:

	Payments Due by Year Ended December 31,				
(In $000s)	2010	2011 - 2012	2013 - 2014	2015 and After	Total
Deferred compensation plan payments (1)	$ 2,752	$ 5,161	$ 799	$ 5,646	$ 14,358
Long-term debt (2)	14,763	85,494	193,926	—	294,183
Operating lease obligations (3)	14,933	26,755	20,398	55,982	118,068
Purchase obligations	4,610	—	—	—	4,610
Other long-term liabilities (4)	419	2,624	—	—	3,043
Other contractual cash obligations (5)	11,547	19,739	2,013	18,000	51,299
Total contractual cash obligations	$ 49,024	$ 139,773	$ 217,136	$ 79,628	$ 485,561

(1) Includes scheduled payments under a non-qualified deferred compensation plan and long-term performance awards earned by certain employees.

(2) Includes scheduled principal payments, repayment of outstanding revolving loans, and estimated interest payments on outstanding borrowings under the Third Amended Credit Agreement. Estimated interest payments are as follows: $12.8 million for fiscal 2010, $19.5 million for fiscal 2011 and 2012, and $5.9 million for fiscal 2013 and 2014.

(3) Excludes total sublease income of $2.4 million.

(4) Includes estimated earnout payments related to the acquisition of HealthHonors in October 2009. We have excluded long-term liabilities of $1.1 million related to uncertain tax positions as we are unable to reasonably estimate the timing of these payments in individual years due to uncertainties in the timing of effective settlement of tax positions.

(5) Other contractual cash obligations primarily represent a perpetual license agreement and 25-year strategic relationship agreement that we entered into in January 2008. We have remaining contractual cash obligations of $35.0 million related to these agreements, $15.0 million of which will occur ratably during the next three years, and the remaining $20.0 million of which will occur ratably over the following 20 years.

Recently Issued Accounting Standards

In April 2009, the FASB issued authoritative guidance requiring disclosures about fair value of financial instruments in both interim reporting periods of publicly traded companies as well as in annual financial statements, beginning with interim reporting periods ending after June 15, 2009. The implementation of this guidance resulted in increased disclosures in our interim periods but did not have an impact on our financial position or results of operations.

In May 2009, the FASB issued guidance which establishes accounting and disclosure requirements for subsequent events. The guidance defines subsequent events as events that occur after the balance sheet date but before the financial statements are issued for public entities. It requires companies to disclose the date through which they have evaluated subsequent events and to designate subsequent events as either recognized or non-recognized. In February 2010, the FASB issued revised guidance, effectively immediately for all financial statements that had not yet been issued, to remove the requirement for SEC filers to disclose the date through which they have evaluated subsequent events. The original guidance became effective for interim or annual periods ending after June 15, 2009. The implementation of this guidance, as revised, resulted in increased disclosures but did not have an impact on our financial position or results of operations.

In June 2009, the FASB approved the FASB Accounting Standards Codification (the "Codification"). Effective July 1, 2009, the Codification is the single source of authoritative nongovernmental U.S. GAAP, superseding existing FASB, American Institute of Certified Public Accountants ("AICPA"), Emerging Issues Task Force ("EITF"), and related accounting literature. The Codification reorganizes the thousands of U.S. GAAP pronouncements into approximately 90 accounting topics and displays them using a consistent structure. Also included is relevant Securities and Exchange Commission guidance organized using the same topical structure in separate sections.

In December 2007, the FASB issued guidance regarding business combinations. This guidance expands the definition of a business and a business combination and generally requires the acquiring entity to recognize all of the assets and liabilities of the acquired business, regardless of the percentage ownership acquired, at their fair values. It also requires that contingent consideration and certain acquired contingencies be recorded at fair value on the acquisition date and that acquisition costs generally be expensed as incurred. The guidance was effective for fiscal years beginning after December 15, 2008. The adoption of this guidance did not materially impact our financial position or results of operations when it became effective on January 1, 2009.

Quantitative and Qualitative Disclosures About Market Risk

We are subject to market risk related to interest rate changes, primarily as a result of the Third Amended Credit Agreement, which bears interest based on floating rates. Revolving advances under the Third Amended Credit Agreement generally bear interest, at our option, at 1) LIBOR plus a spread of 0.875% to 1.750% or 2) the greater of the federal funds rate plus 0.5%, or the prime rate, plus a spread of 0.000% to 0.250%. Term loan borrowings bear interest, at our option, at 1) LIBOR plus 1.50% or 2) the greater of the federal funds rate plus 0.5%, or the prime rate.

In order to manage our interest rate exposure under the Third Amended Credit Agreement, we have entered into eight interest rate swap agreements effectively converting our floating rate debt to fixed obligations with interest rates ranging from 3.375% to 4.995%.

A one-point interest rate change would have resulted in interest expense fluctuating approximately $1.0 million for fiscal 2009.

As a result of our investment in international initiatives, as of December 31, 2009 we are also exposed to foreign currency exchange rate risks. Because a significant portion of these risks is economically hedged with currency options and forwards contracts and because our international initiatives are not yet material to our consolidated results of operations, a 10% change in foreign currency exchange rates would not have had a material impact on our results of operations or financial position for fiscal 2009. We do not execute transactions or hold derivative financial instruments for trading purposes.

Financial Statements and Supplementary Data

Consolidated Balance Sheets

Assets

(In thousands)	December 31, 2009	August 31, 2008
Current assets:		
Cash and cash equivalents	$ 2,356	$ 35,242
Accounts receivable, net	100,833	113,312
Prepaid expenses	10,433	8,992
Other current assets	4,945	5,275
Income taxes receivable	6,452	—
Deferred tax asset	24,197	24,948
Total current assets	149,216	187,769
Property and equipment:		
Leasehold improvements	40,609	37,475
Computer equipment and related software	166,448	131,296
Furniture and office equipment	28,096	29,209
Capital projects in process	23,052	12,052
	258,205	210,032
Less accumulated depreciation	(134,046)	(98,971)
	124,159	111,061
Other assets	11,498	16,575
Customer contracts, net	29,343	34,521
Other intangible assets, net	71,704	72,582
Goodwill, net	496,446	484,305
Total assets	$ 882,366	$ 906,813

See accompanying notes to the consolidated financial statements.

Consolidated Balance Sheets

Liabilities and Stockholders' Equity

(In thousands, except share and per share data)	December 31, 2009	August 31, 2008
Current liabilities:		
Accounts payable	$ 29,171	$ 18,753
Accrued salaries and benefits	58,212	31,612
Accrued liabilities	25,004	23,555
Deferred revenue	4,639	6,422
Contract billings in excess of earned revenue	70,440	75,454
Income taxes payable	—	3,984
Current portion of long-term debt	2,192	2,837
Current portion of long-term liabilities	3,854	3,876
Total current liabilities	193,512	166,493
Long-term debt	254,345	345,395
Long-term deferred tax liability	14,617	9,364
Other long-term liabilities	42,615	31,227
Stockholders' equity:		
Preferred stock		
$.001 par value, 5,000,000 shares authorized, none outstanding	—	—
Common stock		
$.001 par value, 120,000,000 and 75,000,000 shares authorized, 33,858,917 and 33,603,320 shares outstanding	34	34
Additional paid-in capital	222,472	207,918
Retained earnings	158,880	147,772
Accumulated other comprehensive loss	(4,109)	(1,390)
Total stockholders' equity	377,277	354,334
Total liabilities and stockholders' equity	$ 882,366	$ 906,813

See accompanying notes to the consolidated financial statements.

Consolidated Statements of Operations

(In thousands, except share and per share data)	Year Ended December 31, 2009	Four Months Ended December 31, 2008	Year Ended August 31, 2008	Year Ended August 31, 2007
Revenues	**$ 717,426**	$ 244,737	$ 736,243	$ 615,586
Cost of services (exclusive of depreciation and amortization of $35,433, $11,805, $34,105, and $27,677, respectively, included below)	**522,999**	177,651	503,940	417,721
Selling, general and administrative expenses	**71,535**	27,790	71,342	67,352
Depreciation and amortization	**49,289**	16,188	47,479	37,044
Impairment loss	**—**	4,344	—	—
Restructuring and related charges	**—**	10,264	—	—
Operating income	**73,603**	8,500	113,482	93,469
Gain on sale of investment	**(2,581)**	—	—	—
Interest expense	**15,717**	6,757	20,927	18,185
Legal settlement and related costs	**39,956**	—	—	—
Income before income taxes	**20,511**	1,743	92,555	75,284
Income tax expense	**10,137**	1,009	37,740	30,163
Net income	**$ 10,374**	$ 734	$ 54,815	$ 45,121
Earnings per share:				
Basic	**$ 0.31**	$ 0.02	$ 1.57	$ 1.29
Diluted	**$ 0.30**	$ 0.02	$ 1.50	$ 1.22
Weighted average common shares and equivalents				
Basic	**33,730**	33,616	34,977	35,049
Diluted	**34,359**	34,038	36,597	37,002

See accompanying notes to the consolidated financial statements.

Consolidated Statement of Changes in Stockholders' Equity

(In thousands)	Preferred Stock	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
Balance, August 31, 2006	**$ —**	**$ 35**	**$140,200**	**$134,622**	**$16**	**$274,873**
Comprehensive income:						
Net income	—	—	—	45,121	—	45,121
Net change in fair value of interest rate swap, net of income tax benefit of $133					($205)	($205)
Foreign currency translation adjustment	—	—	—	—	137	137
Total comprehensive income						45,053
Sale of unregistered common stock	—	—	5,000	—	—	5,000
Repurchases of common stock	—	—	(552)	(5,102)	—	(5,654)
Exercise of stock options and other	—	—	11,221	—	—	11,221
Tax benefit of option exercises	—	—	13,421	—	—	13,421
Share-based employee compensation expense	—	—	18,836	—	—	18,836
Balance, August 31, 2007	**$ —**	**$ 35**	**$188,126**	**$174,641**	**$(52)**	**$362,750**
Cumulative effect of a change in accounting principle – adoption of FIN 48	—		—	(687)	—	(687)
Comprehensive income:						
Net income	—	—	—	54,815	—	54,815
Net change in fair value of interest rate swap, net of income tax benefit of $1,064	—	—	—	—	(1,510)	(1,510)
Foreign currency translation adjustment	—	—	—	—	172	172
Total comprehensive income						53,477
Repurchases of common stock	—	(2)	(13,341)	(80,997)	—	(94,340)
Exercise of stock options and other	—	1	6,710	—	—	6,711
Tax benefit of option exercises	—	—	9,893	—	—	9,893
Share-based employee compensation expense	—	—	16,530	—	—	16,530
Balance, August 31, 2008	**$ —**	**$ 34**	**$207,918**	**$147,772**	**$(1,390)**	**$354,334**
Comprehensive income:						
Net income	—	—	—	734	—	**734**
Net change in fair value of interest rate swaps, net of income tax benefit of $3,371	—	—	—	—	(5,007)	(5,007)
Change in fair value of investment, net of income taxes of $1,094	—	—	—	—	1,607	1,607
Foreign currency translation adjustment	—	—	—	—	(175)	(175)
Total comprehensive loss						(2,841)
Write-off of deferred tax assets related to the repurchase of stock options	—	—	(9,088)	—	—	(9,088)
Exercise of stock options	—	—	56	—	—	56
Tax effect of option exercises	—	—	(340)	—	—	(340)
Share-based employee compensation expense	—	—	14,915	—	—	14,915
Balance, December 31, 2008	**$ —**	**$ 34**	**$213,461**	**$148,506**	**$(4,965)**	**$357,036**
Comprehensive income:						
Net income	—	—	—	10,374	—	10,374
Net change in fair value of interest rate swaps, net of income taxes of $1,783	—	—	—	—	2,418	2,418
Change in fair value of investment, net of income tax benefit of $49	—	—	—	—	(71)	(71)
Sale of investment, net of income taxes of $1,045	—	—	—	—	(1,536)	(1,536)
Foreign currency translation adjustment	—	—	—	—	45	45
Total comprehensive income						11,230
Repurchase of stock options	—	—	(736)	—	—	(736)
Exercise of stock options	—	—	727	—	—	727
Tax effect of option exercises	—	—	(1,193)	—	—	(1,193)
Share-based employee compensation expense	—	—	10,213	—	—	10,213
Balance, December 31, 2009	**$ —**	**$ 34**	**$ 222,472**	**$158,880**	**$(4,109)**	**$377,277**

See accompanying notes to the consolidated financial statements.

Consolidated Statements of Cash Flows

(In thousands)	Year Ended December 31, 2009	Four Months Ended Dec. 31, 2008	Year Ended August 31, 2008	Year Ended August 31, 2007
Cash flows from operating activities:				
Net income	**$ 10,374**	$ 734	$ 54,815	$ 45,121
Adjustments to reconcile net income to net cash provided by operating activities, net of business acquisitions:				
Depreciation and amortization	**49,289**	16,188	47,479	37,044
Gain on sale of investment	**(2,581)**	—	—	—
Loss on disposal of property and equipment	**1,584**	1,568	—	—
Impairment loss	**—**	4,344	—	—
Amortization of deferred loan costs	**1,518**	415	1,168	991
Share-based employee compensation expense	**10,213**	14,915	16,530	18,836
Excess tax benefits from share-based payment arrangements	**(381)**	(68)	(9,480)	(12,152)
Decrease (increase) in accounts receivable, net	**14,352**	(1,796)	(33,131)	(2,749)
(Increase) decrease in other current assets	**(1,972)**	(3,011)	3,927	(3,299)
Increase (decrease) in accounts payable	**6,565**	(3,620)	2,516	(1,143)
Increase (decrease) in accrued salaries and benefits	**24,991**	1,549	12,652	(21,362)
(Decrease) increase in other current liabilities	**(11,067)**	3,374	11,491	52,227
Deferred income taxes	**8,076**	(14,133)	(10,835)	(10,866)
Other	**6,049**	1,672	11,761	5,092
(Increase) decrease in other assets	**(172)**	540	(1,367)	834
Payments on other long-term liabilities	**(3,970)**	(504)	(2,220)	(1,247)
Net cash flows provided by operating activities	**112,868**	22,167	105,306	107,327
Cash flows from investing activities:				
Acquisition of property and equipment	**(49,110)**	(13,753)	(82,521)	(29,507)
Sale of investment	**11,626**	—	—	—
Business acquisitions, net of cash acquired, and equity investments	**(19,486)**	(449)	—	—
Change in restricted cash	**(538)**	—	(452)	(493,071)
Purchase of investment	**—**	—	—	(9,045)
Other	**(4,918)**	(2,208)	(3,690)	(13)
Net cash flows used in investing activities	**(62,426)**	(16,410)	(86,663)	(531,636)
Cash flows from financing activities:				
Proceeds from issuance of long-term debt	**405,400**	55,000	85,420	350,000
Deferred loan costs	**(784)**	(290)	—	(4,357)
Proceeds from sale of unregistered common stock	**—**	—	—	5,000
Repurchases of common stock	**—**	—	(94,340)	(5,654)
Repurchase of stock options	**(736)**	—	—	—
Excess tax benefits from share-based payment arrangements	**381**	68	9,480	12,152
Exercise of stock options	**727**	56	6,711	11,221
Payments of long-term debt	**(457,303)**	(96,825)	(38,327)	(51,190)
Change in outstanding checks and other	**(1,113)**	6,149	—	—
Net cash flows (used in) provided by financing activities	**(53,428)**	(35,842)	(31,056)	317,172
Effect of exchange rate changes on cash	**185**	—	—	—
Net decrease in cash and cash equivalents	**(2,801)**	(30,085)	(12,413)	(107,137)
Cash and cash equivalents, beginning of period	**5,157**	35,242	47,655	154,792
Cash and cash equivalents, end of period	**$ 2,356**	$ 5,157	$ 35,242	$ 47,655
Supplemental disclosure of cash flow information:				
Cash paid during the period for interest	**$ 12,717**	$ 8,297	$ 19,117	$ 14,042
Cash paid during the period for income taxes	**$ 18,390**	$ 10,914	$ 41,249	$ 38,580

See accompanying notes to the consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Year Ended December 31, 2009, Four Months Ended December 31, 2008, and Years Ended August 31, 2008 and 2007

1. Summary of Significant Accounting Policies

Healthways, Inc. and its wholly-owned subsidiaries provide specialized, comprehensive solutions to help people improve physical, emotional and social well-being, reducing both direct healthcare costs and the costs associated with the loss of health-related employee productivity. In North America, our customers include health plans, governments, employers, pharmacy benefit managers, and hospitals in all 50 states, the District of Columbia and Puerto Rico. We also provide health improvement programs and services in Germany, Brazil and Australia.

a. Principles of Consolidation - The consolidated financial statements include the accounts of the Company and its subsidiaries, all of which are wholly-owned. We have eliminated all intercompany profits, transactions and balances.

b. Cash and Cash Equivalents - Cash and cash equivalents primarily include tax-exempt debt instruments, commercial paper, and other short-term investments with original maturities of less than three months.

c. Accounts Receivable, net - Billed receivables primarily represent fees that are contractually due in the ordinary course of providing our services, net of contractual adjustments and allowances for doubtful accounts. Unbilled receivables primarily represent fees for services based on the estimated utilization of fitness facilities and are generally billed in the following month. Historically, we have experienced minimal instances of customer non-payment and therefore consider our accounts receivable to be collectible, but we may provide reserves, when appropriate, for doubtful accounts and for billing adjustments (such as data reconciliation differences) on a specific identification basis.

d. Property and Equipment - Property and equipment is carried at cost and includes expenditures that increase value or extend useful lives. We recognize depreciation using the straight-line method over useful lives of three to seven years for computer software and hardware and four to seven years for furniture and other office equipment. Leasehold improvements are depreciated over the shorter of the estimated life of the asset or the life of the lease, which ranges from two to fifteen years. Depreciation expense for the year ended December 31, 2009, the four months ended December 31, 2008, and the years ended August 31, 2008 and 2007 was $36.6 million, $12.1 million, $31.5 million, and $25.6 million, respectively, including amortization of assets recorded under capital leases.

e. Other Assets - Other assets consist primarily of long-term investments and deferred loan costs net ofaccumulated amortization.

f. Intangible Assets - Intangible assets are initially recognized and measured at cost. Intangible assets subject to amortization primarily include customer contracts, acquired technology, patents, distributor and provider networks, and other intangible assets which we amortize on a straight-line basis over estimated useful lives ranging from three to 25 years. We assess the potential impairment of intangible assets subject to amortization whenever events or changes in circumstances indicate that the carrying values may not be recoverable.

Intangible assets not subject to amortization at December 31, 2009 and August 31, 2008 consist of trade names of $29.9 million and $33.4 million, respectively. We review intangible assets not subject to amortization on an annual basis or more frequently whenever events or circumstances indicate that the assets might be impaired. See Note 4 for further information on intangible assets.

g. Goodwill - We recognize goodwill for the excess of the purchase price over the fair value of tangible and identifiable intangible net assets of businesses that we acquire.

We review goodwill at the reporting unit level (operating segment or one level below an operating segment) on an annual basis or more frequently whenever events or circumstances indicate that the carrying value may not be recoverable. We estimate the fair value of each reporting unit using a discounted cash flow model and reconcile the aggregate fair value of our reporting units to our consolidated market capitalization. We allocate goodwill to reporting units based on the reporting unit expected to benefit from the combination. We completed our annual impairment test during our fourth quarter and concluded that no impairment of goodwill exists.

h. Contract Billings in Excess of Earned Revenue - Contract billings in excess of earned revenue primarily represent performance-based fees subject to refund that we have not recognized as revenues because either 1) data from the customer is insufficient or incomplete to measure performance; or 2) interim performance measures indicate that we are not meeting performance targets.

i. Income Taxes - We file a consolidated federal income tax return that includes all of our domestic wholly-owned subsidiaries. U.S. GAAP generally requires that we record deferred income taxes for the tax effect of differences between the book and tax bases of our assets and liabilities. We recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position are measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement.

j. Revenue Recognition - We generally determine our contract fees by multiplying a contractually negotiated rate per member per month ("PMPM") by the number of members covered by our services during the month. We typically set the PMPM rates during contract negotiations with customers based on the value we expect our programs to create and a sharing of that value between the customer and the Company. In addition, some of our services, such as the SilverSneakers fitness program, are billed on a fee for service basis.

Some of our contracts provide that a portion (up to 100%) of our fees may be refundable to the customer ("performance-based") if our programs do not achieve, when compared to a baseline year, a targeted percentage reduction in the customer's healthcare costs and selected clinical and/or other criteria that focus on improving the health of the members. Approximately 4% of revenues recorded during fiscal 2009 were performance-based and were subject to final reconciliation as of December 31, 2009. We anticipate that this percentage will fluctuate due to the level of performance-based fees in new contracts and the timing and amount of revenue recognition associated with performance-based fees. Some contracts also provide opportunities for us to receive incentive bonuses in excess of the contractual PMPM rate if we exceed contractual performance targets.

We generally bill our customers each month for the entire amount of the fees contractually due for the prior month's enrollment, which typically includes the amount, if any, that is performance-based and may be subject to refund should we not meet performance targets. Deferred revenues can arise from contracts which permit up front billing and collection of fees covering the entire contractual service period, generally 12 months. Contractually, we cannot bill for any incentive bonus until after contract settlement. Fees for service are typically billed in the month after the services are provided.

We recognize revenue as follows: 1) we recognize the fixed portion of PMPM fees and fees for service as revenue during the period we perform our services; 2) we recognize the performance-based portion of the monthly fees based on the most recent assessment of our performance, which represents the amount that the customer would legally be obligated to pay if the contract were terminated as of the latest balance sheet date; and 3) we recognize additional incentive bonuses based on the most recent assessment of our performance, to the extent we consider such amounts collectible.

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

In 2005, we began participating in two Medicare Health Support pilots, which concluded in January 2008 and July 2008, respectively. Substantially all of the fees under these pilots were performance-based. Our original cooperative agreements required that, by the end of the third year, we achieve a cumulative net savings (total savings for the intervention population as compared to the control group less fees received from the Centers for Medicare & Medicaid Services ("CMS")) of 5.0%. Under an amendment to our agreement for our stand-alone Medicare Health Support pilot in

Maryland and the District of Columbia, we began serving a "refresh population" of approximately 4,500 beneficiaries on August 1, 2006, which was measured as a separate cohort for two years, by the end of which the program was required to achieve a 2.5% cumulative net savings when compared to a new control cohort. In April 2008, we signed an amendment to our Medicare Health Support protocol with CMS, which changed the financial performance target for both the initial and the refresh populations to budget neutrality. In late April 2009, we received the final reconciliation report from CMS' independent financial reconciliation contractor. Based upon this final reconciliation report as well as our performance over the term of the pilots, we have recognized $9.5 million of cumulative performance-based fees related to these pilots and $12.2 million of fixed fees. At December 31, 2009, approximately $57.8 million of performance-based fees related to these pilots was recorded in contract billings in excess of earned revenue, $50.3 million of which related to fees collected, and the remaining $7.5 million of which related to fees billed but not collected due to CMS withholding payment of these fees. We submitted our objections to the final reconciliation report and engaged in discussions with CMS regarding our objections. We, along with several other participating organizations in the Medicare Health Support pilots, have submitted a proposal to CMS to resolve the issues related to the reconciliation; however, such proposal remains subject to approval by the United States government.

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

During the settlement process under a contract, which generally occurs six to eight months after the end of a contract year, we settle any performance-based fees and reconcile healthcare claims and clinical data. As of December 31, 2009, performance-based fees that have not yet been settled with our customers but that have been recognized as revenue in the current and prior years totaled approximately $46.4 million, all of which was based on actual data received from our customers. Data reconciliation differences, for which we provide contractual allowances until we reach agreement with respect to identified issues, can arise between the customer and us due to customer data deficiencies, omissions, and/or data discrepancies.

Performance-related adjustments (including any amounts recorded as revenue that were ultimately refunded), changes in estimates, data reconciliation differences, or adjustments to incentive bonuses may cause us to recognize or reverse revenue in a current fiscal year that pertains to services provided during a prior fiscal year. During fiscal 2009, we recognized a net increase in revenue of approximately $8.6 million that related to services provided prior to fiscal 2009.

k. Earnings Per Share – We calculate basic earnings per share using weighted average common shares outstanding during the period. We calculate diluted earnings per share using weighted average common shares outstanding during the period plus the effect of all dilutive potential common shares outstanding during the period. See Note 16 for a reconciliation of earnings per share.

l. Share-Based Compensation – We recognize all share-based payments to employees, including grants of employee stock options, in the statement of operations based on their fair values. See Note 13 for further information on share-based compensation.

m. Derivative Instruments and Hedging Activities – We record all derivatives at estimated fair value as either assets or liabilities on the balance sheet and recognize the unrealized gains and losses in either the balance sheet or statement of operations, depending on whether the derivative is designated as a hedging instrument. As permitted under

our master netting arrangements, beginning September 30, 2009, the fair value amounts of our derivative instruments are presented on a net basis by counterparty in the consolidated balance sheet. See Note 6 for further information.

n. Management Estimates – In preparing our consolidated financial statements in conformity with generally accepted accounting principles, management must make estimates and assumptions that affect: 1) the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements; and 2) the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

o. Fiscal Year - In August 2008, our Board of Directors approved a change in our fiscal year-end from August 31 to December 31. Accordingly, our 2009 fiscal year began on January 1, 2009 following a four-month transition period ended December 31, 2008. References herein to fiscal 2009 refer to the year ended December 31, 2009; references herein to fiscal 2008 and fiscal 2007 refer to the years ended August 31, 2008 and 2007, respectively.

2. Recently Issued Accounting Standards

In April 2009, the Financial Accounting Standards Board ("FASB") issued authoritative guidance requiring disclosures about fair value of financial instruments in both interim reporting periods of publicly traded companies as well as in annual financial statements, beginning with interim reporting periods ending after June 15, 2009. The implementation of this guidance resulted in increased disclosures in our interim periods but did not have an impact on our financial position or results of operations.

In May 2009, the FASB issued guidance which establishes accounting and disclosure requirements for subsequent events. The guidance defines subsequent events as events that occur after the balance sheet date but before the financial statements are issued for public entities. It requires companies to disclose the date through which they have evaluated subsequent events and to designate subsequent events as either recognized or non-recognized. In February 2010, the FASB issued revised guidance, effectively immediately for all financial statements that had not yet been issued, to remove the requirement for SEC filers to disclose the date through which they have evaluated subsequent events. The original guidance became effective for interim or annual periods ending after June 15, 2009. The implementation of this guidance, as revised, resulted in increased disclosures but did not have an impact on our financial position or results of operations.

In June 2009, the FASB approved the FASB Accounting Standards Codification (the "Codification"). Effective July 1, 2009, the Codification is the single source of authoritative nongovernmental U.S. GAAP, superseding existing FASB, American Institute of Certified Public Accountants ("AICPA"), Emerging Issues Task Force ("EITF"), and related accounting literature. The Codification reorganizes the thousands of U.S. GAAP pronouncements into approximately 90 accounting topics and displays them using a consistent structure. Also included is relevant Securities and Exchange Commission guidance organized using the same topical structure in separate sections.

In December 2007, the FASB issued guidance regarding business combinations. This guidance expands the definition of a business and a business combination and generally requires the acquiring entity to recognize all of the assets and liabilities of the acquired business, regardless of the percentage ownership acquired, at their fair values. It also requires that contingent consideration and certain acquired contingencies be recorded at fair value on the acquisition date and that acquisition costs generally be expensed as incurred. The guidance was effective for fiscal years beginning after December 15, 2008. The adoption of this guidance did not materially impact our financial position or results of operations when it became effective on January 1, 2009.

3. Goodwill

The change in carrying amount of goodwill during the year ended August 31, 2008, four months ended December 31, 2008, and year ended December 31, 2009 is shown below:

(In $000s)	
Balance, August 31, 2007	$ 483,584
Health IQ purchase price adjustment	475
Axia purchase price adjustment and other	246
Balance, August 31, 2008	$ 484,305
Earn-out payments	291
Balance, December 31, 2008	$ 484,596
HealthHonors purchase	11,850
Balance, December 31, 2009	$ 496,446

In October 2009, we acquired HealthHonors, a behavioral economics company that specializes in behavior change science and optimized use of incentives, for a net cash payment of $14.5 million and a multi-year earn-out arrangement with an acquisition date fair value of $3.0 million.

4. Intangible Assets

Intangible assets subject to amortization at December 31, 2009 consisted of the following:

(In $000s)	Gross Carrying Amount	Accumulated Amortization	Net
Customer contracts	$ 55,240	$ 25,897	$ 29,343
Acquired technology	26,757	19,009	7,748
Patents	23,405	5,419	17,986
Distributor and provider networks	8,709	3,765	4,944
Other	12,486	1,410	11,076
Total	$ 126,597	$ 55,500	$ 71,097

Intangible assets subject to amortization at August 31, 2008 consisted of the following:

(In $000s)	Gross Carrying Amount	Accumulated Amortization	Net
Customer contracts	$ 53,140	$ 18,619	$ 34,521
Acquired technology	22,657	15,115	7,542
Patents	22,840	2,397	20,443
Distributor and provider networks	8,709	2,137	6,572
Other	5,470	838	4,632
Total	$ 112,816	$ 39,106	$ 73,710

Intangible assets subject to amortization are being amortized over estimated useful lives ranging from three to 25 years. Total amortization expense for the year ended December 31, 2009, four months ended December 31, 2008 and years ended August 31, 2008 and 2007 was $12.7 million, $4.0 million, $16.0 million, and $11.5 million, respectively. The following table summarizes the estimated amortization expense for each of the next five years and thereafter:

Year ending December 31,	(In $000s)
2010	12,316
2011	12,376
2012	10,472
2013	10,404
2014	10,404
2015 and thereafter	15,125
Total	$ 71,097

Intangible assets not subject to amortization at December 31, 2009 and August 31, 2008 consist of trade names of $29.9 million and $33.4 million, respectively.

5. Income Taxes

Income tax expense (benefit) is comprised of the following:

(In $000s)	**Year Ended December 31, 2009**	Four Months Ended December 31, 2008	Year Ended August 31, 2008	Year Ended August 31, 2007
Current taxes				
Federal	**$ 835**	$ 11,946	$ 47,147	$ 34,187
State	**754**	2,827	9,569	6,465
Deferred taxes				
Federal	**7,638**	(11,308)	(15,500)	(8,618)
State	**910**	(2,456)	(3,476)	(1,871)
Total	**$ 10,137**	$ 1,009	$ 37,740	$ 30,163

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. The following table shows the significant components of our net deferred tax asset (liability) as of December 31, 2009 and August 31, 2008:

(In $000s)	**December 31, 2009**	August 31, 2008
Deferred tax asset:		
Accruals and reserves	**$ 10,710**	$ 9,537
Deferred compensation	**9,253**	8,270
Share-based payments	**15,877**	17,644
Net operating loss carryforwards	**8,344**	7,936
Other assets and liabilities	**3,381**	2,341
Advance receipts	**14,220**	16,381
	61,785	62,109
Valuation allowance	**(1,648)**	(1,239)
	60,137	60,870
Deferred tax liability:		
Property and equipment	**(22,668)**	(13,895)
Intangible assets	**(27,805)**	(31,316)
Other assets and liabilities	**(84)**	(75)
	(50,557)	(45,286)
Net deferred tax asset	**$ 9,580**	$ 15,584
Net current deferred tax asset	**$ 24,197**	$ 24,948
Net long-term deferred tax liability	**(14,617)**	(9,364)
	$ 9,580	$ 15,584

The valuation allowance increased by $0.4 million from August 31, 2008 to December 31, 2009 due to an increase in the valuation allowance against deferred tax assets in non-U.S. jurisdictions with a recent history of losses. Based on the Company's historical and expected future taxable earnings, and a consideration of available tax planning strategies, management believes it is more likely than not that the Company will realize the benefit of the existing deferred tax assets, net of the valuation allowance, at December 31, 2009.

For fiscal 2009, 2008, and 2007, the tax benefit of stock option compensation, excluding the tax benefit related to the deferred tax asset for share-based payments, was recorded as additional paid-in capital. We recorded a tax effect of $1.8 million in fiscal 2009, a tax benefit of $1.1 million in fiscal 2008, and a tax benefit of $0.1 million in fiscal 2007 related to our interest rate swap agreements (see Note 6) to stockholders' equity as a component of other comprehensive income (loss).

At December 31, 2009, we had foreign net operating loss carryforwards, before valuation allowances, of approximately $5.9 million with an indefinite carryforward period and approximately $17.7 million of federal loss carryforwards originating from acquired entities. The federal loss carryforwards are subject to an annual limitation under Internal Revenue Code Section 382 and also have expiration dates ranging from 2011 until 2025.

The difference between income tax expense computed using the statutory federal income tax rate and the effective rate is as follows:

(In $000s)	Year Ended December 31, 2009	Four Months Ended Dec. 31, 2008	Year Ended August 31, 2008	Year Ended August 31, 2007
Statutory federal income tax	**$ 7,179**	$ 610	$ 32,394	$ 26,349
State income taxes, less federal income tax benefit	**970**	62	3,910	3,133
Other	**1,988**	337	1,436	681
Income tax expense	**$ 10,137**	$ 1,009	$ 37,740	$ 30,163

Uncertain Tax Positions

As of December 31, 2009 and August 31, 2008, we had $1.1 million and $0.3 million, respectively, of unrecognized tax benefits that, if recognized, would affect our effective tax rate. Our policy is to include interest and penalties related to unrecognized tax benefits in income tax expense. As of December 31, 2009 and August 31, 2008, we had accrued interest related to uncertain tax positions of $0 and $1.5 million, respectively, on our balance sheet. During fiscal 2009, the four months ended December 31, 2008, and fiscal 2008, we included approximately $0.2 million, $0.1 million, and $0.5 million, respectively, of net interest related to uncertain tax positions as a component of income tax expense.

The aggregate changes in the balance of unrecognized tax benefits were as follows:

(In $000s)	
Unrecognized tax benefits at September 1, 2007	$ 11,050
Decreases based on tax positions related to fiscal 2008	(8,534)
Lapse of statutes of limitation	(140)
Unrecognized tax benefits at August 31, 2008 and December 31, 2008	2,376
Change based upon settlements with taxing authorities	(2,376)
Increases based upon tax positions related to fiscal 2009	1,072
Unrecognized tax benefits at December 31, 2009	$ 1,072

We file income tax returns in the U.S. Federal jurisdiction and in various state and foreign jurisdictions. During 2009, the Internal Revenue Service completed an audit of our 2005 and 2006 tax years, the resolution of which did not result in a material adjustment to our financial statements.

6. Derivative Instruments and Hedging Activities

We use derivative instruments to manage risks related to interest rates and foreign currencies. We record all derivatives at estimated fair value as either assets or liabilities on the balance sheet and recognize the unrealized gains and losses in either the balance sheet or statement of operations, depending on whether the derivative is designated as a hedging instrument. As permitted under our master netting arrangements, at December 31, 2009, the fair value amounts of our derivative instruments are presented on a net basis by counterparty in the consolidated balance sheet.

Interest Rate

We currently maintain eight interest rate swap agreements to reduce our exposure to interest rate fluctuations on our floating rate debt commitments (see Note 8 for further information). These interest rate swap agreements effectively modify our exposure to interest rate risk by converting a portion of our floating rate debt to fixed obligations with interest rates ranging from 3.375% to 4.995%, thus reducing the impact of interest rate changes on future interest expense. Under these agreements, we receive a variable rate of interest based on LIBOR, and we pay a fixed rate of interest plus a spread of 0.875% to 1.750% on revolving advances and a spread of 1.50% on term loan borrowings. We have designated these interest rate swap agreements as qualifying cash flow hedges.

Foreign Currency

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

The estimated gross fair values of derivative instruments at December 31, 2009, excluding the impact of netting derivative assets and liabilities when a legally enforceable master netting agreement exists, were as follows:

(In $000s)	Foreign currency exchange contracts	Interest rate swap agreements
Assets:		
Derivatives designated as hedging instruments:		
Other assets	$ —	$ 88
Total assets	$ —	$ 88
Liabilities:		
Derivatives not designated as hedging instruments:		
Accrued liabilities	$ 12	$ —
Derivatives designated as hedging instruments:		
Accrued liabilities	—	236
Other long-term liabilities	—	6,942
Total liabilities	$ 12	$ 7,178

See also Note 7.

Cash Flow Hedges

Derivative instruments that are designated and qualify as cash flow hedges are recorded at estimated fair value in the balance sheet, with the effective portion of the gains and losses being reported in other comprehensive income ("OCI") or loss. These gains and losses are reclassified into earnings in the same period during which the hedged transaction affects earnings or the period in which all or a portion of the hedge becomes ineffective. As of December 31, 2009, we expect to reclassify $5.2 million of net losses on interest rate swap agreements from accumulated OCI to interest expense within the next 12 months due to the scheduled payment of interest associated with floating rate debt.

As of December 31, 2009, we are a party to the following interest rate swap agreements for which we receive a variable rate of interest based on LIBOR and for which we pay the following fixed rates of interest plus a spread of 0.875% to 1.750% on revolving advances and a spread of 1.50% on term loan borrowings:

Swap #	Original Notional Amount (in $000s)	Fixed Interest Rate	Termination Date
1	$184,000	4.995%	March 31, 2010 (1)
2	46,000	4.995%	March 31, 2010 (2)
3	40,000	3.433%	December 30, 2011
4	50,000	3.688%	December 30, 2011
5	40,000	3.855%	December 30, 2011 (3)
6	30,000	3.760%	March 30, 2011 (4)
7	57,500	3.385%	December 31, 2013 (5)
8	57,500	3.375%	December 31, 2013 (6)

(1) The principal value of this swap agreement amortizes over a 39-month period. During the three months ended December 31, 2009, the notional amount of this swap was $16 million.
(2) The principal value of this swap agreement amortizes over a 39-month period. During the three months ended December 31, 2009, the notional amount of this swap was $4 million.
(3) This swap agreement became effective October 1, 2009.
(4) This swap agreement became effective January 2, 2010.
(5) This swap agreement becomes effective January 1, 2012. The principal value of this swap agreement will amortize over a 24-month period.
(6) This swap agreement becomes effective January 3, 2012. The principal value of this swap agreement will amortize over a 24-month period.

We currently meet the hedge accounting criteria under U.S. GAAP in accounting for these interest rate swap agreements.

Gains and losses representing either hedge ineffectiveness or hedge components excluded from the assessment of effectiveness are recognized in current earnings. The following table shows the effect of our cash flow hedges on the consolidated statement of operations (or when applicable, the consolidated balance sheet) during the year ended December 31, 2009:

	Year Ended December 31, 2009		
Derivatives in Cash Flow Hedging Relationships	Amount of Gain (Loss) Recognized in OCI on Derivatives (Effective Portion)	Location of Gain (Loss) Reclassified from Accumulated OCI into Income (Effective Portion)	Amount of Gain (Loss) Reclassified from Accumulated OCI into Income (Effective Portion)
Interest rate swap agreements, gross of tax effect	$(2,541)	Interest expense	$(6,742)

During the year ended December 31, 2009, there were no gains or losses on cash flow hedges recognized in income resulting from hedge ineffectiveness.

Derivative Instruments Not Designated as Hedging Instruments

Our foreign currency exchange contracts require current period mark-to-market accounting, with any change in fair value being recorded each period in the statement of operations in selling, general and administrative expenses. As of December 31, 2009, we had the following outstanding net foreign currency forward contract that was entered into to hedge forecasted foreign net income (loss) and intercompany debt.

Foreign Currency	Notional Amount (000s)
Australian Dollar	AUD 1,180

Our forward contracts did not have a material effect on our consolidated statement of operations during the year ended December 31, 2009.

7. Fair Value Measurements

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

Fair Value Hierarchy

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

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

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

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

Assets and Liabilities Measured at Fair Value on a Recurring Basis

The following table presents our assets and liabilities measured at fair value on a recurring basis at December 31, 2009:

(In 000s)	Level 2	Level 3	Gross Fair Value	Netting [1]	Net Fair Value
Assets:					
Interest rate swap agreements	$ 88	$ —	$ 88	$ —	$ 88
Liabilities:					
Foreign currency exchange contracts	$ 12	$ —	$ 12	$ —	$ 12
Interest rate swap agreements	7,178	—	7,178	—	7,178
Contingent consideration liability	—	3,043	3,043	—	3,043

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

The fair values of forward foreign currency exchange contracts are valued using broker quotations of similar assets or liabilities in active markets. The fair values of interest rate swap agreements are primarily determined based on the present value of future cash flows using internal models and third-party pricing services with observable inputs, including interest rates, yield curves and applicable credit spreads. The contingent consideration liability represents the fair value of a multi-year earn-out arrangement in connection with a business combination entered into during the fourth quarter of 2009. The fair value was determined using a discounted cash flow model based on management's estimate of future cash flows.

The change in the contingent consideration liability during the year ended December 31, 2009 was as follows:

(In $000s)	Contingent Consideration Liability
Balance, January 1, 2009	$ —
Initial recognition of liability	3,043
Balance, December 31, 2009	$ 3,043

Assets and Liabilities Measured at Fair Value on a Non-Recurring Basis

We measure certain assets at fair value on a nonrecurring basis in the fourth quarter of our fiscal year, including the following:

- reporting units measured at fair value in the first step of a goodwill impairment test; and
- indefinite-lived intangible assets measured at fair value for impairment assessment.

Each of the assets above is classified as Level 3 within the fair value hierarchy. Based on their estimated fair values, we did not record any impairment losses during the three months ended December 31, 2009.

We estimate the fair value of each reporting unit using a discounted cash flow model and reconcile the aggregate fair value of our reporting units to our consolidated market capitalization. The discounted cash flow model requires significant judgments, including management's estimate of future cash flows, which is dependent on internal forecasts, estimation of the long-term growth rate for our business, the useful life over which cash flows will occur, and determination of our weighted average cost of capital. Changes in these estimates and assumptions could materially affect the estimate of fair value and goodwill impairment for each reporting unit.

We estimate the fair value of indefinite-lived intangible assets, which consist of a trade name, using a present value technique, which requires management's estimate of future revenues attributable to this trade name, estimation of the long-term growth rate for these revenues, and determination of our weighted average cost of capital. Changes in these estimates and assumptions could materially affect the estimate of fair value for the trade name.

Fair Value of Other Financial Instruments

In addition to foreign currency exchange contracts and interest rate swap agreements, the estimated fair values of which are disclosed above, the estimated fair value of each class of financial instruments at December 31, 2009 was as follows:

- Cash and cash equivalents – The carrying amount of $2.4 million approximates fair value because of the short maturity of those instruments (less than three months).
- Long-term debt –The estimated fair value of outstanding borrowings under the Third Amended Credit Agreement is based on the average of the prices set by the issuing bank given current market conditions and is not necessarily indicative of the amount we could realize in a current market exchange. The estimated fair value and carrying amount of outstanding borrowings under the Third Amended Credit Agreement at December 31, 2009 are $239.8 million and $256.0 million, respectively.

8. Long-Term Debt

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

Revolving advances under the Third Amended Credit Agreement generally bear interest, at our option, at 1) LIBOR plus a spread of 0.875% to 1.750% or 2) the greater of the federal funds rate plus 0.5%, or the prime rate, plus a spread of 0.000% to 0.250%. Term loan borrowings bear interest, at our option, at 1) LIBOR plus 1.50% or 2) the greater of the federal funds rate plus 0.5%, or the prime rate. See Note 6 for a description of our interest rate swap agreements. The Third Amended Credit Agreement also provides for a fee ranging between 0.150% and 0.300% of unused commitments. The Third Amended Credit Agreement is secured by guarantees from most of the Company's domestic subsidiaries and by security interests in substantially all of the Company's and such subsidiaries' assets.

We are required to repay outstanding revolving loans on the revolving commitment termination date, which is December 1, 2011. We are required to repay term loans in quarterly principal installments aggregating $0.5 million each, which commenced on March 31, 2007, and the entire unpaid principal balance of the term loans is due and payable at maturity on December 1, 2013.

The following table summarizes the minimum annual principal payments and repayments of the revolving advances under the Third Amended Credit Agreement for each of the next five years and thereafter:

Year ending December 31,	(In $000s)
2010	2,000
2011	64,000
2012	2,000
2013	188,000
2014	—
2015 and thereafter	—
Total	$ 256,000

The Third Amended Credit Agreement contains various financial covenants, which require us to maintain, as defined, ratios or levels of 1) total funded debt to EBITDA, 2) fixed charge coverage, and 3) net worth. In connection with a legal settlement (see Note 11), in March 2009 we entered into a sixth amendment to the Third Amended Credit Agreement to expressly exclude up to $40 million of expenses attributable to this settlement from the calculation of earnings before interest, taxes, depreciation and amortization, or EBITDA, for purposes of covenant calculations. The Third Amended Credit Agreement also restricts the payment of dividends and limits the amount of repurchases of the Company's common stock. As of December 31, 2009, we were in compliance with all of the covenant requirements of the Third Amended Credit Agreement.

As described in Note 6 above, as of December 31, 2009, we are a party to eight interest rate swap agreements for which we receive a variable rate of interest based on LIBOR and for which we pay a fixed rate of interest plus a spread of 0.875% to 1.750% on revolving advances and a spread of 1.50% on term loan borrowings.

9. Other Long-Term Liabilities

We have a non-qualified deferred compensation plan under which our officers may defer a portion of their salaries and receive a Company matching contribution plus a contribution based on our performance. Company contributions vest at 25% per year. We do not fund the plan and carry it as an unsecured obligation. Participants in the plan elect payout dates for their account balances, which can be no earlier than four years from the period of the deferral.

As of December 31, 2009, and August 31, 2008, other long-term liabilities included vested amounts under the non-qualified deferred compensation plan of $7.8 million and $7.9 million, respectively, net of the current portions of $2.7 million. For the next five years ended December 31, we must make estimated plan payments of $2.7 million, $0.3 million, $1.0 million, $0.8 million, and $0.1 million, respectively.

10. Restructuring and Related Charges and Impairment Loss

In 2008, we began a restructuring of the Company primarily focused on streamlining management and better positioning the Company to deliver fully integrated solutions, which was largely completed by the end of calendar 2008. Through December 31, 2009, we had incurred cumulative net charges of approximately $9.2 million. These restructuring charges primarily consisted of severance costs, net of equity forfeitures, and costs associated with capacity consolidation. For the four months ended December 31, 2008, these charges were presented in a separate line on the consolidated statement of operations.

During the year ended December 31, 2009, we recorded net credits of approximately ($1.0) million related to this restructuring, which are included in cost of services and selling, general, and administrative expenses. We do not expect to incur significant additional costs or adjustments related to this restructuring.

The change in accrued restructuring and related charges during the year ended December 31, 2009 was as follows:

(In 000s)	
Accrued restructuring and related charges at January 1, 2009	$ 10,460
Additions	191
Payments	(8,082)
Adjustments (1)	(1,162)
Accrued restructuring and related charges at December 31, 2009	$ 1,407

(1) Adjustments for the year ended December 31, 2009 resulted from actual severance amounts differing from initial estimates due to employees who were expected to be terminated but were instead transitioned to new roles, as well as a favorable adjustment to lease termination costs due to unanticipated demand for certain unused office space.

In December 2008, we decided to discontinue offering one of our products as a standalone program. As a result of this decision we did not renew the expiring trade name associated with this product and recorded an impairment loss of $4.3 million in December 2008 to write off this intangible asset.

11. Commitments and Contingencies

Former Employee Action

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

Healthways, Inc. was subsequently dismissed as a defendant. In addition, WPMC settled claims filed against it as part of a larger settlement agreement that WPMC's parent organization, HCA Inc., reached within the United States government. The plaintiff dismissed his claims against the medical directors with prejudice, and on February 7, 2007 the court granted the plaintiff's motion and dismissed all claims against all named medical directors.

Effective as of April 1, 2009, the Company and AHSI entered into a settlement agreement with the United States of America, acting through the United States Department of Justice and on behalf of the Department of Health and Human Services (collectively, the "United States"), and the former employee in connection with the settlement of the lawsuit. Pursuant to the settlement agreement, we paid $28 million to the United States in settlement of the litigation. Additionally, we paid an additional $12 million for other costs and fees related to the settlement, including the estimated legal costs and expenses of the plaintiff's attorneys. As a result of the settlement, the court has dismissed the lawsuit with prejudice.

In a related matter, we have settled the arbitration claim filed against us by WPMC and the arbitration counter-claim we filed against WPMC in February 2006, both of which sought indemnification for certain costs and expenses incurred in connection with the qui tam case. The arbitration has been dismissed with prejudice.

Securities Class Action Litigation

Beginning on June 5, 2008, Healthways and certain of its present and former officers and/or directors were named as defendants in two putative securities class actions filed in the U.S. District Court for the Middle District of Tennessee, Nashville Division. On August 8, 2008, the court ordered the consolidation of the two related cases, appointed lead plaintiff and lead plaintiff's counsel, and granted lead plaintiff leave to file a consolidated amended complaint.

The amended complaint, filed on September 22, 2008, alleges that the Company and the individual defendants violated Sections 10(b) of the Securities Exchange Act of 1934 (the "Act") and that the individual defendants violated Section 20(a) of the Act as "control persons" of Healthways. The amended complaint further alleges that certain of the individual defendants also violated Section 20A of the Act based on their stock sales. The plaintiff purports to bring these claims for unspecified monetary damages on behalf of a class of investors who purchased Healthways stock between July 5, 2007 and August 25, 2008.

In support of these claims, the lead plaintiff alleges generally that, during the proposed class period, the Company made misleading statements and omitted material information regarding (1) the purported loss or restructuring of certain contracts with customers, (2) the Company's participation in the Medicare Health Support ("MHS") pilot program for the Centers for Medicare & Medicaid Services, and (3) the Company's guidance for fiscal year 2008. The defendants filed a motion to dismiss the amended complaint on November 13, 2008. On March 9, 2009, the Court denied the defendants' motion to dismiss. The parties have exchanged discovery requests, and the discovery phase of the lawsuit is presently underway.

Shareholder Derivative Lawsuits

Also, on June 27, 2008 and July 24, 2008, respectively, two shareholders filed putative derivative actions purportedly on behalf of Healthways in the Chancery Court for the State of Tennessee, Twentieth Judicial District, Davidson County, against certain directors and officers of the Company. These actions are based upon substantially the same facts alleged in the securities class action litigation described above. The plaintiffs are seeking to recover damages in an unspecified amount and equitable and/or injunctive relief.

On August 13, 2008, the Court consolidated these two lawsuits and appointed lead counsel. On October 3, 2008, the Court ordered that the consolidated action be stayed until the motion to dismiss in the securities class action had been resolved by the District Court. By stipulation of the parties, the plaintiffs filed their consolidated complaint on May 9, 2009. On June 19, 2009, the defendants filed a motion to dismiss the consolidated complaint. The Court granted the defendants' motion to dismiss on October 14, 2009. The plaintiffs filed a notice of appeal on November 12, 2009.

ERISA Lawsuits

Additionally, on July 31, 2008, a purported class action alleging violations of the Employee Retirement Income Security Act ("ERISA") was filed in the U.S. District Court for the Middle District of Tennessee, Nashville Division against Healthways, Inc. and certain of its directors and officers alleging breaches of fiduciary duties to participants in the Company's 401(k) plan. The central allegation is that Company stock was an imprudent investment option for the 401(k) plan.

An amended complaint was filed on September 29, 2008, naming as defendants the Company, the Board of Directors, certain officers, and members of the Investment Committee charged with administering the 401(k) plan. The amended complaint alleged that the defendants violated ERISA by failing to remove the Company stock fund from the 401(k) plan when it allegedly became an imprudent investment, by failing to disclose adequately the risks and results of the MHS pilot program to 401(k) plan participants, and by failing to seek independent advice as to whether to continue to permit the plan to hold Company stock. It further alleged that the Company and its directors should have been more closely monitoring the Investment Committee and other plan fiduciaries. The amended complaint sought damages in an undisclosed amount and other equitable relief. The defendants filed a motion to dismiss on October 29, 2008. On January 28,

2009, the Court granted the defendants' motion to dismiss the plaintiff's claims for breach of the duty to disclose with regard to any non-public information and information beyond the specific disclosure requirements of ERISA and denied Defendants' motion to dismiss as to the remainder of the plaintiff's claims. A period of discovery ensued.

On May 12, 2009, the plaintiff filed a motion for class certification. After the plaintiff failed, without explanation, to appear for his scheduled deposition, the Court issued an Order on July 10, 2009 warning the plaintiff that his failure to participate in the lawsuit could result in sanctions, including but not limited to dismissal. After the plaintiff's failure to participate continued, on July 23, 2009, the defendants filed a motion to dismiss for failure to prosecute the action. On August 6, 2009, the parties filed a stipulation of dismissal with prejudice as to the named plaintiff but otherwise without prejudice, and the Court entered an Order to that effect on the same date.

On February 1, 2010, a new named plaintiff filed another putative class action complaint in the United States District Court for the Middle District of Tennessee, Nashville Division, alleging ERISA violations in the administration of the Company's 401(k) plan. The new complaint is identical to the original complaint, including the allegations and the requests for relief. Defendants' answer to this complaint is due to be filed on or about March 22, 2010.

Outlook

We are also subject to other contractual disputes, claims and legal proceedings that arise from time to time in the ordinary course of our business. We currently are involved in a contractual dispute with a customer regarding fees paid to us as part of a former contractual relationship. We believe we performed our services in compliance with the contractual requirements and the customer's assertions are without merit. In the event the parties are unable to resolve the dispute, the parties will proceed to arbitration as specified in the applicable agreement. While we are unable to estimate a range of potential losses, we do not believe that the contractual disputes or any of the legal proceedings pending against us as of the date of this report will have a material adverse effect on our liquidity or financial condition; however, we may settle disputes, claims, sustain judgments or incur expenses relating to these matters in a particular fiscal quarter which may adversely affect our results of operations. As these matters are subject to inherent uncertainties, our view of these matters may change in the future.

Contractual Commitment

In January 2008, we entered into a perpetual license agreement and 25-year strategic relationship agreement. We have remaining contractual cash obligations of $35.0 million related to these agreements, $15.0 million of which will occur ratably during the next three years, and the remaining $20.0 million of which will occur ratably over the following 20 years.

12. Leases

We maintain operating lease agreements principally for our corporate office space, our call centers, and our operations support and training offices. We lease approximately 264,000 square feet of office space in Franklin, Tennessee, which contains our corporate headquarters and one of our call centers. This lease commenced in March 2008 and expires in February 2023. We also lease office space for our 12 other call center locations for an aggregate of approximately 294,000 square feet of space with lease terms expiring on various dates from 2010 to 2015. Our operations support and training offices contain approximately 130,000 square feet in aggregate and have lease terms expiring from 2010 to 2016.

Our corporate office lease agreement contains escalation clauses and provides for two renewal options of five years each at then prevailing market rates. The base rent for the initial 15-year term will range from $4.2 million to $6.3 million per year over the term of the lease. The landlord provided a tenant improvement allowance equal to $39.20 per square foot. We record leasehold improvement incentives as deferred rent and amortize them as reductions to rent expense over the lease term. We recognize rent expense on a straight-line basis over the lease term.

Most of our operating leases include escalation clauses, some of which are fixed amounts, and some of which reflect changes in price indices. Certain operating leases contain renewal options to extend the lease for additional periods. For the year ended December 31, 2009, four months ended December 31, 2008, and years ended August 31, 2008 and 2007, rent expense under lease agreements was approximately $14.5 million, $5.0 million, $16.9 million, and $10.6 million, respectively. Our capital lease obligations are included in long-term debt and the current portion of long-term debt.

The following table summarizes our future minimum lease payments, net of total sublease income of $2.4 million, under all non-cancelable operating leases for each of the next five years:

(In $000s)	
Year ending December 31,	Operating Leases
2010	$ 14,380
2011	13,593
2012	11,931
2013	10,363
2014	9,385
2015 and thereafter	55,982
Total minimum lease payments	$ 115,634

13. Share-Based Compensation

We have several shareholder-approved stock incentive plans for employees and directors. We currently have three types of share-based awards outstanding under these plans: stock options, restricted stock, and restricted stock units. We believe that such awards align the interests of our employees and directors with those of our stockholders.

We grant options under these plans at market value on the date of grant. The options generally vest over or at the end of four years based on service conditions and expire seven or ten years from the date of grant. Restricted share awards generally vest over or at the end of four years. We recognize share-based compensation expense on a straight-line basis over the vesting period. Certain option and restricted share awards generally provide for accelerated vesting upon a change in control or normal or early retirement (as defined in the plans). At December 31, 2009, we have reserved approximately 0.9 million shares for future equity grants under our stock incentive plans.

On December 30, 2008, we completed an offer to purchase from our employees, excluding the chief executive officer and Board of Directors, outstanding options to acquire shares of common stock of the Company that were granted between September 1, 2004 and August 15, 2008 under our shareholder-approved stock option plans (the "Tender Offer"). We purchased stock options representing the right to acquire 1.1 million shares of the Company's common stock in exchange for $0.7 million in cash. We also recognized $11.5 million of additional stock-based compensation expense in December 2008, which represented the remaining compensation cost for these options as measured at the grant date but not yet recognized prior to the completion of the Tender Offer on December 30, 2008.

Following are certain amounts recognized in the statement of operations for share-based compensation arrangements for the year ended December 31, 2009, four months ended December 31, 2008, and years ended August 31, 2008 and 2007. We did not capitalize any share-based compensation costs during these periods.

(In millions)	Year Ended December 31, 2009	Four Months Ended December 31, 2008	Year Ended August 31, 2008	Year Ended August 31, 2007
Total share-based compensation	**$ 10.2**	$ 14.9 [1]	$ 16.5	$ 18.8
Share-based compensation included in cost of services	**4.4**	9.1	8.0	8.4
Share-based compensation included in selling, general and administrative expenses	**5.8**	5.8	8.5	10.4
Total income tax benefit recognized	**4.0**	5.9	6.5	7.4

(1) Includes $11.5 million of additional expense related to the Tender Offer described above.

As of December 31, 2009, there was $19.9 million of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the stock incentive plans. That cost is expected to be recognized over a weighted average period of 1.9 years.

Stock Options

We use a lattice-based binomial option valuation model ("lattice binomial model") to estimate the fair values of stock options. During fiscal 2007, we based expected volatility on both historical volatility and implied volatility from traded options on the Company's stock. Beginning in fiscal 2008, we based expected volatility on historical volatility due to the low volume of traded options on our stock. The expected term of options granted is derived from the output of the lattice binomial model and represents the period of time that options granted are expected to be outstanding. We used historical data to estimate expected option exercise and post-vesting employment termination behavior within the lattice binomial model.

The following table shows the weighted average grant-date fair values of options and the weighted average assumptions we used to develop the fair value estimates under each of the option valuation models for the year ended December 31, 2009, four months ended December 31, 2008, and years ended August 31, 2008 and 2007:

	Year Ended December 31, 2009	Four Months Ended December 31, 2008	Year Ended August 31, 2008	Year Ended August 31, 2007
Weighted average grant-date fair value of options	**$ 6.72**	$ 4.97	$ 22.16	$ 22.08
Assumptions:				
Expected volatility	**51.6%**	46.5%	37.8%	48.7 %
Expected dividends	**—**	—	—	—
Expected term (in years)	**6.1**	5.1	6.6	5.5
Risk-free rate	**2.5%**	3.6%	4.2%	5.1 %

A summary of option activity as of December 31, 2009 and the changes during the year then ended is presented below:

Options	Shares (000s)	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value ($000s)
Outstanding at January 1, 2009	4,124	$ 20.20		
Granted	1,153	11.69		
Exercised	(115)	6.50		
Forfeited or expired	(226)	21.73		
Outstanding at December 31, 2009	4,936	18.46	4.8	$ 22,763
Exercisable at December 31, 2009	3,433	19.45	3.3	$ 13,702

The total intrinsic value, which represents the difference between the underlying stock's market price and the option's exercise price, of options exercised during the year ended 2009, four months ended December 31, 2008, and years ended 2008 and 2007 was $1.0 million, $0.2 million, $27.5 million, and $35.9 million, respectively.

Cash received from option exercises under all share-based payment arrangements during fiscal 2009 was $0.7 million. The actual tax benefit realized during fiscal 2009 for the tax deductions from option exercises totaled $0.9 million. We issue new shares of common stock upon exercise of stock options.

Restricted Stock and Restricted Stock Units

The fair value of restricted stock and restricted stock units ("nonvested shares") is determined based on the closing bid price of the Company's common stock on the grant date. The weighted average grant-date fair value of nonvested shares granted during the year ended December 31, 2009, four months ended December 31, 2008, and years ended August 31, 2008 and 2007 was $11.10, $9.20, $43.17 and $43.76, respectively.

The following table shows a summary of our nonvested shares as of December 31, 2009 as well as activity during the year then ended. The total fair value of shares vested during the year ended December 31, 2009, four months ended December 31, 2008, and years ended 2008 and 2007 was $3.9 million, $1.5 million, $0.8 million, and $0.5 million, respectively.

Nonvested Shares	Shares (000s)	Weighted Average Grant Date Fair Value
Nonvested at January 1, 2009	501	$ 41.01
Granted	666	11.10
Vested	(88)	44.19
Forfeited	(64)	23.24
Nonvested at December 31, 2009	1,015	22.21

14. Sale of Investment

In January 2009, a private company in which we held preferred stock (recorded in "other assets") was acquired by a third party. As part of this sale, we received two payments totaling $11.6 million in January and February 2009 and recorded a gain of $2.6 million during the first quarter of 2009.

15. Comprehensive Income

Comprehensive income (loss), net of income taxes, was $11.2 million, ($2.8) million, $53.5 million, and $45.1 million for the year ended December 31, 2009, four months ended December 31, 2008, and years ended August 31, 2008 and 2007, respectively.

16. Earnings Per Share

The following is a reconciliation of the numerator and denominator of basic and diluted earnings per share for the year ended December 31, 2009, four months ended December 31, 2008, and years ended August 31, 2008 and 2007:

(In 000s, except per share data)	**Year Ended December 31, 2009**	Four Months Ended December 31 , 2008	Year Ended August 31, 2008	Year Ended August 31, 2007
Numerator:				
Net income - numerator for basic earnings per share	**$ 10,374**	$ 734	$ 54,815	$ 45,121
Denominator:				
Shares used for basic earnings per share	**33,730**	33,616	34,977	35,049
Effect of dilutive stock options and restricted stock units outstanding:				
Non-qualified stock options	**336**	270	1,477	1,887
Restricted stock units	**293**	152	143	66
Shares used for diluted earnings per share	**34,359**	34,038	36,597	37,002
Earnings per share:				
Basic	**$ 0.31**	$ 0.02	$ 1.57	$ 1.29
Diluted	**$ 0.30**	$ 0.02	$ 1.50	$ 1.22
Dilutive securities outstanding not included in the computation of earnings per share because their effect is antidilutive:	**3,707**	3,088	1,658	1,117

17. Unaudited Financial Information

Below are the unaudited statement of operations and statement of cash flows for the four months ended December 31, 2007:

(In 000s, except per share data)	Four Months Ended December 31, 2007
Revenues	$ 234,277
Cost of services (exclusive of depreciation and amortization)	163,750
Selling, general and administrative expenses	21,741
Depreciation and amortization	13,682
Operating income	35,104
Interest expense	7,118
Income before income taxes	27,986
Income tax expense	11,506
Net income	$ 16,480
Earnings per share:	
Basic	$ 0.46
Diluted	$ 0.44
Weighted average common shares and equivalents	
Basic	35,770
Diluted	37,739

(In thousands)	Four Months Ended December 31, 2007
Cash flows from operating activities:	
Net income	$ 16,480
Adjustments to reconcile net income to net cash provided by operating activities, net of business acquisitions:	
Depreciation and amortization	13,682
Loss on disposal of property and equipment	221
Amortization of deferred loan costs	389
Share-based employee compensation expense	5,057
Excess tax benefits from share-based payment arrangements	(6,072)
Increase in accounts receivable, net	(12,084)
Decrease in other current assets	1,513
Decrease in accounts payable	(2,429)
Increase in accrued salaries and benefits	1,848
Increase in other current liabilities	10,257
Deferred income taxes	(3,025)
Other	3,951
Decrease in other assets	303
Payments on other long-term liabilities	(111)
Net cash flows provided by operating activities	29,980
Cash flows from investing activities:	
Acquisition of property and equipment	(25,045)
Acquisitions, net of cash acquired	(15)
Net cash flows used in investing activities	(25,060)
Cash flows from financing activities:	
Repurchases of common stock	(132)
Excess tax benefits from share-based payment arrangements	6,072
Exercise of stock options	3,070
Payments of long-term debt	(21,070)
Net cash flows used in financing activities	(12,060)
Net decrease in cash and cash equivalents	(7,140)
Cash and cash equivalents, beginning of period	47,655
Cash and cash equivalents, end of period	$ 40,515

18. Stockholder Rights Plan

On June 19, 2000, the Board of Directors adopted a stockholder rights plan under which holders of common stock as of June 30, 2000 received preferred stock purchase rights as a dividend at the rate of one right per share. As amended in June 2004 and July 2006, each right initially entitles its holder to purchase one one-hundredth of a Series A preferred share at $175.00, subject to adjustment. Upon becoming exercisable, each right will allow the holder (other than the person or group whose actions have triggered the exercisability of the rights), under alternative circumstances, to buy either securities of the Company or securities of the acquiring company (depending on the form of the transaction) having a value of twice the then current exercise price of the rights.

With certain exceptions, each right will become exercisable only when a person or group acquires, or commences a tender or exchange offer for, 15% or more of our outstanding common stock. Rights will also become exercisable in the event of certain mergers or asset sales involving more than 50% of our assets or earning power. The rights will expire on June 15, 2014. The Board of Directors of the Company reviews the plan at least once every three years to determine if the maintenance and continuance of the plan is still in the best interests of the Company and its stockholders.

19. Employee Benefits

We have a 401(k) Retirement Savings Plan (the "Plan") available to substantially all of our employees. Employees can contribute up to a certain percentage of their base compensation as defined in the Plan. The Company matching contributions are subject to vesting requirements. Company contributions under the Plan totaled $3.9 million, $1.3 million, $4.3 million, and $3.8 million for the year ended December 31, 2009, four months ended December 31, 2008, and years ended August 31, 2008 and 2007, respectively.

20. Segment Disclosures

We have aggregated our operating segments into one reportable segment, well-being improvement services. Our integrated well-being improvement product line includes programs for various diseases, conditions, and wellness programs. It is impracticable for us to report revenues by program. Further, we report revenues from our external customers on a consolidated basis since well-being improvement is the only service that we provide.

During fiscal 2009 as well as the four months ended December 31, 2008, we derived approximately 19% of our revenues from one customer, with no other customer comprising 10% or more of our revenues. In fiscal 2008, two customers each comprised 10% or more of our revenues. Revenues from each of these customers individually totaled approximately 20% and 10%, respectively, of fiscal 2008 revenues. In fiscal 2007, we derived approximately 22% of our revenues from one customer, with no other customer comprising 10% or more of our revenues.

21. Quarterly Financial Information (unaudited)

(In thousands, except per share data) Twelve Months Ended December 31, 2009	First (1)	Second	Third	Fourth
Revenues	$ 182,736	$ 177,836	$ 181,642	$ 175,212
Gross margin	$ 41,112	$ 41,534	$ 40,627	$ 35,720
Income (loss) before income taxes	$ (22,572)	$ 15,534	$ 15,484	$ 12,065
Net income (loss)	$ (14,813)	$ 8,876	$ 8,802	$ 7,509
Basic earnings (loss) per share (2)	$ (0.44)	$ 0.26	$ 0.26	$ 0.22
Diluted earnings (loss) per share (2)	$ (0.44) (3)	$ 0.26	$ 0.26	$ 0.22

Twelve Months Ended December 31, 2008	First	Second	Third	Fourth (4)
Revenues	$ 180,940	$ 193,044	$ 187,448	$ 185,272
Gross margin	$ 44,324	$ 55,604	$ 52,504	$ 40,438
Income (loss) before income taxes	$ 17,366	$ 27,673	$ 26,012	$ (4,744)
Net income (loss)	$ 10,203	$ 16,325	$ 15,623	$ (3,087)
Basic earnings (loss) per share (2)	$ 0.28	$ 0.48	$ 0.46	$ (0.09)
Diluted earnings (loss) per share (2)	$ 0.27	$ 0.46	$ 0.45	$ (0.09) (3)

(1) Includes a legal settlement of approximately $40.0 million.
(2) We calculated earnings per share for each of the quarters based on the weighted average number of shares and dilutive options outstanding for each period. Accordingly, the sum of the quarters may not necessarily be equal to the full year income per share.
(3) The assumed exercise of stock-based compensation awards for this period was not considered because the impact would have been anti-dilutive.
(4) Includes restructuring and impairment charges of approximately $14.6 million.

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders of Healthways, Inc.

We have audited the accompanying consolidated balance sheets of Healthways, Inc. as of December 31, 2009 and August 31, 2008, and the related consolidated statements of operations, stockholders' equity, and cash flows for the years ended December 31, 2009, August 31, 2008 and August 31, 2007, and the four months ended December 31, 2008. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Healthways, Inc. at December 31, 2009 and August 31, 2008, and the consolidated results of its operations and its cash flows for the years ended December 31, 2009, August 31, 2008 and August 31, 2007, and the four months ended December 31, 2008, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 5 to the consolidated financial statements, the Company changed its method of accounting for income tax contingencies with the adoption of the guidance originally issued in FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes-An Interpretation of FASB Statement No. 109 (codified in FASB ASC Topic 740, Income Taxes) effective September 1, 2007.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Healthways, Inc.'s internal control over financial reporting as of December 31, 2009, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 16, 2010 expressed an unqualified opinion thereon.

Ernst & Young LLP

Nashville, Tennessee
March 16, 2010

Management's Annual Report on Internal Control over Financial Reporting

Management, including the principal executive officer and principal financial officer, is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting (as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934) is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies and procedures may deteriorate.

Management has performed an assessment of the effectiveness of the Company's internal control over financial reporting as of December 31, 2009 based on criteria established by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO"), Internal Controls - Integrated Framework, and believes that the COSO framework is a suitable framework for such an evaluation. Management has concluded that the Company's internal control over financial reporting was effective as of December 31, 2009.

Ernst & Young LLP, the independent registered public accounting firm that audited the Company's consolidated financial statements for the year ended December 31, 2009, has issued an attestation report on the Company's internal control over financial reporting which is included in this Annual Report on Form 10-K.

Our chief executive officer and chief financial officer have reviewed and evaluated the effectiveness of our "disclosure controls and procedures" (as defined in Rule 13a-15(e) and 15d-15(e) promulgated under the Securities Exchange Act of 1934 (the "Exchange Act")) as of December 31, 2009. Based on that evaluation, the chief executive officer and chief financial officer have concluded that our disclosure controls and procedures are effective. They are designed to ensure that information required to be disclosed in the reports that the Company files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specific in the Commission's rules and forms and to ensure that information required to be disclosed in the reports that the Company files or submits under the Exchange Act is accumulated and communicated to management, including our chief executive officer and chief financial officer, to allow timely decision regarding required disclosure.

There have been no changes in our internal controls over financial reporting during the quarter ended December 31, 2009 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders of Healthways, Inc.

We have audited Healthways, Inc.'s internal control over financial reporting as of December 31, 2009, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Healthways, Inc.'s management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Annual Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Healthways, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2009, based on the COSO criteria .

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Healthways, Inc. as of December 31, 2009 and August 31, 2008, and the related consolidated statements of operations, stockholders' equity, and cash flows for the years ended December 31, 2009, August 31, 2008 and August 31, 2007, and the four months ended December 31, 2008 of Healthways, Inc. and our report dated March 16, 2010 expressed an unqualified opinion thereon.

Ernst & Young LLP

Nashville, Tennessee
March 16, 2010

Form 10-K/Investor Contact

A copy of the Healthways, Inc. Annual Report on Form 10-K for fiscal 2009 filed with the Securities and Exchange Commission is available on the Company's website, www.healthways.com. It is also available from the Company (without exhibits) at no charge. These requests and other investor contacts should be directed to Chip Wochomurka, Director, Investor Relations, at the Company's corporate office.

Annual Meeting

The annual meeting of stockholders will be held on May 28, 2010, at 9:00 a.m. at the Franklin Marriott Cool Springs, 700 Cool Springs Boulevard, Franklin, Tennessee.

Common Stock and Dividend Information

The common stock of Healthways, Inc. is traded on The Nasdaq Stock Market under the symbol HWAY. At March 5, 2010, there were approximately 16,500 holders of the common stock, including 191 stockholders of record. No cash dividends have been paid on the common stock.

The following table sets forth the high and low sales prices per share of common stock as reported by Nasdaq for the relevant periods.

Year Ended December 31, 2009	High	Low
First Quarter	$ 15.52	$ 7.01
Second Quarter	14.78	8.27
Third Quarter	16.86	12.03
Fourth Quarter	19.44	13.31
Four Months Ended December 31, 2008	**$ 19.96**	**$ 5.35**
Year Ended August 31, 2008		
First Quarter	$ 60.88	$ 48.99
Second Quarter	71.22	28.43
Third Quarter	37.79	29.68
Fourth Quarter	34.60	18.57

Reconciliation of Non-GAAP Measures to GAAP Measures (Unaudited)

Reconciliation of Adjusted EPS to Diluted EPS, GAAP Basis

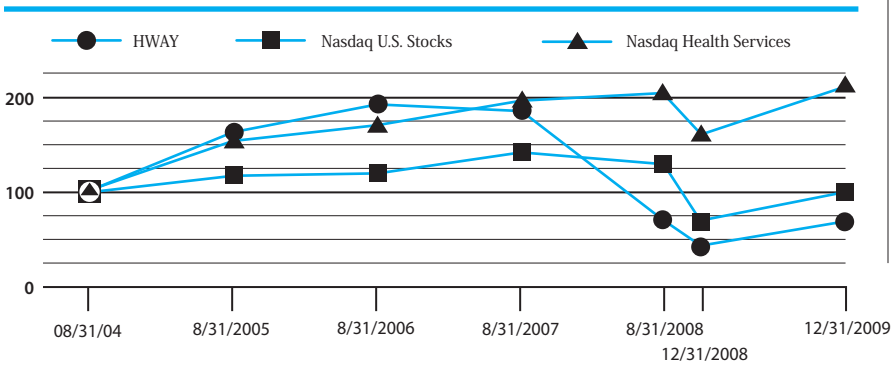
	Twelve Months Ended December 31, 2009	Twelve Months Ended December 31, 2008
Adjusted EPS [1]	**$ 1.04**	$ 1.57
EPS (loss) attributable to lawsuit settlement costs [2]	**(0.73)**	—
EPS (loss) attributable to restructuring initiative and stock option tender offer [3]	—	(0.47)
EPS, GAAP basis [4]	**$ 0.30**	$ 1.10

(1) Adjusted EPS is a non-GAAP financial measure. The Company excludes EPS (loss) attributable to lawsuit settlement costs, restructuring initiative and stock option tender offer from this measure because of its comparability to the Company's historical operating results. The Company believes it is useful to investors to provide disclosures of its operating results on the same basis as that used by management. You should not consider Adjusted EPS in isolation or as a substitute for EPS determined in accordance with accounting principles generally accepted in the United States.
(2) EPS (loss) attributable to lawsuit settlement costs consists of pre-tax charges in 2009 of $40.0 million related to the Company's settlement of a qui tam lawsuit.
(3) EPS (loss) attributable to restructuring initiative and stock option tender offer consists of charges in 2008 related to the Company's restructuring initiative, which includes severance costs less employee equity forfeitures, costs related to capacity consolidation and the write-off of an intangible asset, as well as stock-based compensation costs related to a stock option tender offer completed on December 30, 2008.
(4) Figures may not add due to rounding.

Performance Graph

The following graph compares the total stockholder return of $100 invested on August 31, 2004 in (a) the Company, (b) the CRSP Index for Nasdaq Stock Market (U.S. Companies), and (c) the CRSP Index for Nasdaq Health Services Stocks ("Nasdaq Health Services"), assuming the reinvestment of all dividends.

	08/31/04	8/31/05	8/31/06	8/31/07	8/31/08	12/31/08	12/31/09
HWAY	100.0	161.9	191.2	184.4	70.6	42.5	67.9
Nasdaq U.S. Stocks	100.0	117.5	119.8	141.5	129.5	69.3	99.6
Nasdaq Health Services	100.0	151.3	167.6	193.8	201.5	158.8	209.9



Notes:
A. The lines represent annual index levels derived from compounded daily returns that include all dividends.
B. The indexes are reweighted daily, using the market capitalization on the previous trading day.
C. If the monthly interval, based on the fiscal year end, is not a trading day, the preceding trading day is used.
D. The index level for all series was set to $100.00 on August 31, 2004.

The stock price performance shown on the graph above is not necessarily indicative of future price performance.

Corporate Information

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Board of Directors

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Former Executive Vice President and
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First Chicago NBD Corporation

J. Cris Bisgard, M.D., M.P.H.
Former Director of Health Services
Delta Air Lines

Thomas G. Cigarran
Chairman and former
Chief Executive Officer
Healthways, Inc.

Mary Jane England, M.D.
President of Regis College

Ben R. Leedle, Jr.
Chief Executive Officer
Healthways, Inc.

L. Ben Lytle
Former Chairman and Chief
Executive Officer
Axia Health Management, LLC

C. Warren Neel, Ph.D.
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Corporate Governance
University of Tennessee

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Georgetown University
Former Chief Executive Officer
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Former Chairman, President and
Chief Executive Officer
ClinTrials Research, Inc.

Alison Taunton-Rigby, Ph.D.
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John A. Wickens
Former National Health
Plan President
UnitedHealth Group

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Stefen F. Brueckner
President and
Chief Operating Officer

Mary A. Chaput
Vice President and
Chief Financial Officer

Christopher Cigarran
Vice President,
Human Resources

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President, International

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Chief Accounting Officer

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