

ATHENAHEALTH INC  
Form 10-Q  
May 03, 2010

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
Form 10-Q**

(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934**

**For the quarterly period ended March 31, 2010**

**or**

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934**

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

**Commission File Number 001-33689**

**athenahealth, Inc.**

(Exact name of registrant as specified in its charter)

Delaware

04-3387530

(State or other jurisdiction of  
incorporation or organization)

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

311 Arsenal Street, Watertown, Massachusetts

02472

(Address of principal executive offices)

(Zip Code)

617-402-1000

Registrant's telephone number, including area code

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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

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

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

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As of April 29, 2010, there were 33,097,074 shares of the registrant's \$0.01 par value common stock outstanding.

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

|   | March<br>31,<br>2010 | December<br>31,<br>2009 |
|---|----------------------|-------------------------|
| Assets  |                      |                         |
| Current assets:   |                      |                         |
| Cash and cash equivalents                                       | \$ 20,254            | \$ 30,526               |
| Short-term investments  | 58,828               | 52,323                  |
| Accounts receivable net   | 34,232               | 33,323                  |
| Deferred tax assets   | 5,450                | 5,544                   |
| Prepaid expenses and other current assets                       | 6,471                | 4,663                   |
| Total current assets  | 125,235              | 126,379                 |
| Property and equipment net                                      | 30,105               | 24,871                  |
| Restricted cash   | 8,885                | 9,216                   |
| Software development costs net                                  | 2,493                | 2,324                   |
| Purchased intangibles net                                       | 14,030               | 14,490                  |
| Goodwill  | 22,120               | 22,120                  |
| Deferred tax assets   | 10,226               | 10,284                  |
| Other assets  | 1,546                | 1,393                   |
| Total assets  | \$ 214,640           | \$ 211,077              |
| Liabilities & Stockholders Equity                               |                      |                         |
| Current liabilities:  |                      |                         |
| Current portion of long-term debt and capital lease obligations | \$ 3,440             | \$ 3,437                |
| Accounts payable  | 1,769                | 1,880                   |
| Accrued compensation  | 12,364               | 15,774                  |
| Accrued expenses  | 10,374               | 10,781                  |
| Current portion of deferred revenue                             | 4,731                | 4,038                   |
| Interest rate derivative liability                              | 351                  | 291                     |
| Current portion of deferred rent                                | 1,334                | 1,288                   |
| Total current liabilities                                       | 34,363               | 37,489                  |
| Deferred rent, net of current portion                           | 7,098                | 7,444                   |
| Deferred revenue, net of current portion                        | 29,955               | 28,684                  |
| Other long-term liabilities                                     | 1,191                | 1,191                   |
| Debt and capital lease obligations, net of current portion      | 8,423                | 8,951                   |
| Total liabilities   | 81,030               | 83,759                  |

## Commitments and contingencies (note 12)

## Stockholders' equity:

Preferred stock, \$0.01 par value: 5,000 shares authorized; no shares issued and outstanding at March 31, 2010 and December 31, 2009, respectively

Common stock; \$0.01 par value: 125,000 shares authorized; 35,349 shares issued, and 34,072 shares outstanding at March 31, 2010; 35,166 shares issued and 33,888 shares outstanding at December 31, 2009.

|  |                |                |
|--|----------------|----------------|
|  | 353            | 352            |
| Additional paid-in capital                     | 175,767        | 169,715        |
| Treasury stock, at cost, 1,278 shares          | (1,200)        | (1,200)        |
| Accumulated other comprehensive loss           | (111)          | (73)           |
| Accumulated deficit                            | (41,199)       | (41,476)       |
| <br>Total stockholders' equity                 | <br>133,610    | <br>127,318    |
| <br>Total liabilities and stockholders' equity | <br>\$ 214,640 | <br>\$ 211,077 |

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

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

|  | Three Months Ended<br>March 31, |                             |
|--|---------------------------------|-----------------------------|
|  | 2010                            | 2009<br>(as<br>restated)(1) |
| Revenue:   |                                 |                             |
| Business services                                | \$ 52,565                       | \$ 39,895                   |
| Implementation and other                         | 1,912                           | 1,133                       |
| Total revenue                                    | 54,477                          | 41,028                      |
| Expense:   |                                 |                             |
| Direct operating                                 | 23,519                          | 18,561                      |
| Selling and marketing                            | 12,060                          | 6,999                       |
| Research and development                         | 4,074                           | 3,181                       |
| General and administrative                       | 11,677                          | 8,201                       |
| Depreciation and amortization                    | 2,420                           | 1,639                       |
| Total expense                                    | 53,750                          | 38,581                      |
| Operating income                                 | 727                             | 2,447                       |
| Other income (expense):                          |                                 |                             |
| Interest income                                  | 78                              | 402                         |
| Interest expense                                 | (217)                           | (174)                       |
| (Loss) gain on interest rate derivative contract | (60)                            | 192                         |
| Other income                                     | 30                              | 36                          |
| Total other (expense) income                     | (169)                           | 456                         |
| Income before income taxes                       | 558                             | 2,903                       |
| Income tax provision                             | (281)                           | (1,365)                     |
| Net income                                       | \$ 277                          | \$ 1,538                    |
| Net income per share Basic                       | \$ 0.01                         | \$ 0.05                     |
| Net income per share Diluted                     | \$ 0.01                         | \$ 0.04                     |

|  |        |        |
|--|--------|--------|
| Weighted average shares used in computing net income per share |        |        |
| Basic  | 34,014 | 33,418 |
| Diluted  | 35,201 | 34,814 |

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

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



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

|   | Three Months Ended<br>March 31, |                             |
|---|---------------------------------|-----------------------------|
|   | 2010                            | 2009<br>(as<br>restated)(1) |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                      |                                 |                             |
| Net income  | \$ 277                          | \$ 1,538                    |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                 |                             |
| Depreciation and amortization   | 2,880                           | 1,719                       |
| Amortization of premiums (discounts) on investments                               | 381                             | (292)                       |
| Provision for uncollectible accounts  | 213                             | 104                         |
| Deferred income tax   | 152                             | 1,365                       |
| Increase in fair value of contingent consideration                                | 304                             |                             |
| Stock-based compensation expense  | 2,784                           | 1,916                       |
| Loss (gain) on interest rate derivative contract                                  | 60                              | (192)                       |
| Changes in operating assets and liabilities:                                      |                                 |                             |
| Accounts receivable   | (1,122)                         | 295                         |
| Prepaid expenses and other current assets   | (1,808)                         | (181)                       |
| Other long-term assets  | (153)                           | 16                          |
| Accounts payable  | (392)                           | 869                         |
| Accrued expenses  | (4,121)                         | (3,592)                     |
| Deferred revenue  | 1,964                           | 1,218                       |
| Deferred rent   | (300)                           | (283)                       |
| Net cash provided by operating activities   | 1,119                           | 4,500                       |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                      |                                 |                             |
| Capitalized software development costs  | (703)                           | (449)                       |
| Purchases of property and equipment   | (6,836)                         | (2,142)                     |
| Proceeds from sale or disposal of property and equipment                          | 362                             | 1,803                       |
| Proceeds from sales and maturities of investments                                 | 20,750                          | 14,500                      |
| Purchases of short-term investments   | (27,691)                        | (25,762)                    |
| Decrease in restricted cash   | 332                             | 332                         |
| Net cash used in investing activities   | (13,786)                        | (11,718)                    |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                      |                                 |                             |
| Proceeds from issuance of common stock under stock plans                          | 3,269                           | 530                         |
| Payments on long-term debt and capital lease obligations                          | (887)                           | (1,643)                     |
| Net cash provided by (used in) financing activities                               | 2,382                           | (1,113)                     |
| Effects of exchange rate changes on cash and cash equivalent                      | 13                              | (75)                        |
| Net decrease in cash and cash equivalents   | (10,272)                        | (8,406)                     |

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|  |  |           |    |        |
|--|--|-----------|----|--------|
| Cash and cash equivalents at beginning of period     |  | 30,526    |    | 28,933 |
| Cash and cash equivalents at end of period           |  | \$ 20,254 | \$ | 20,527 |
| Supplemental disclosures of non-cash items           | Property and equipment recorded in accounts payable and accrued expenses | \$ 229    | \$ | 538    |
| Supplemental disclosures                             | Cash paid for interest   | \$ 117    | \$ | 90     |
| Supplemental disclosures                             | Change in fair value of contingent consideration                         | \$ 304    | \$ |        |
| Supplemental disclosures                             | Cash paid for taxes  | \$ 983    | \$ |        |
| Property and equipment acquired under capital leases |  | \$ 363    | \$ | 1,803  |

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

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

**Table of Contents****athenahealth, Inc.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited amounts in thousands, except per-share amounts)****1. BASIS OF PRESENTATION**

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States ( GAAP ) for interim financial reporting and as required by Regulation S-X, Rule 10-01. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of the Company s management, the accompanying unaudited condensed consolidated financial statements contain all adjustments (consisting of items of a normal and recurring nature) necessary to present fairly the financial position as of March 31, 2010, and the results of operations and cash flows for the three month period ended March 31, 2010 and 2009. The results of operations for the three month period ended March 31, 2010 are not necessarily indicative of the results to be expected for the full year. When preparing financial statements in conformity with GAAP, we must make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, expenses, and related disclosures at the date of the financial statements. Actual results could differ from those estimates.

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

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

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

As part of the process to finalize our financial results for the year ended December 31, 2009, we undertook a comprehensive review of our significant accounting policies. As a result of our review, we concluded that, in prior and future periods, we will amortize deferred implementation revenue over a longer expected performance period of twelve years in order to reflect the estimated expected customer life. Previously, the expected performance period was estimated based upon the initial customer contract term, which, for the vast majority of contracts, was one year in duration. As a result of these adjustments, we also revised our previously calculated income tax expense for each quarter in 2009 and 2008. All information presented in the condensed consolidated financial statements and the related notes include all such restatement adjustments.

In addition, in connection with the restatement, we have corrected previously issued financial statements for the three months ended March 31, 2009, for the following reclassification items none of which had any effect on net income or shareholders equity for any period: a) reimbursements of out of pocket ( pass through ) expenses which were previously netted against operating expense have been grossed up and included in Implementation and other revenue in the consolidated statements of operations and b) draw downs of the capital leased lines which were previously presented as sources of cash within the financing activities section of the condensed consolidated statements of cash flows have been reclassified as investing activities.

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

**Table of Contents****athenahealth, Inc.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited amounts in thousands, except per-share amounts)*****Summary of increases (decreases) in Net Income***

|   | <b>Three months<br/>ended<br/>March 31,<br/>2009</b> |
|---|--|
| <b>(in thousands, except per share amounts)</b>                 |  |
| Net income, as previously reported                              | \$ 2,338   |
| Net adjustments   |  |
| Implementation revenue  | (1,334)  |
| Income tax provision  | 534  |
| Net income, restated  | \$ 1,538   |
| <b>Basic earning per common share:</b>                          |  |
| Net income, as previously reported                              | \$ 0.07  |
| Net adjustments   |  |
| Implementation revenue  | (0.04)   |
| Income tax provision  | 0.02   |
| Net income, restated  | \$ 0.05  |
| <b>Diluted earning per common share:</b>                        |  |
| Net income, as previously reported                              | \$ 0.07  |
| Net adjustments   |  |
| Implementation revenue  | (0.04)   |
| Income tax provision  | 0.01   |
| Net income, restated  | \$ 0.04  |
| Weighted average shares used in computing net income per share: |  |
| Basic   | 33,418   |
| Diluted   | 34,814   |

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For the Three Months Ended March 31, 2009

|   | As<br>Previously<br>Reported | Adjustments | Reclassifications | As<br>Restated |
|---|------------------------------|-------------|-------------------|----------------|
| Revenue:                                  |                              |             |                   |                |
| Business services                         | \$ 39,895                    | \$          | \$                | \$ 39,895      |
| Implementation and other                  | 2,204                        | (1,334)     | 263               | 1,133          |
| Total revenue                             | 42,099                       | (1,334)     | 263               | 41,028         |
| Expenses:                                 |                              |             |                   |                |
| Direct operating costs                    | 18,298                       |             | 263               | 18,561         |
| Selling and marketing                     | 6,999                        |             |                   | 6,999          |
| Research and development                  | 3,181                        |             |                   | 3,181          |
| General and administrative                | 8,201                        |             |                   | 8,201          |
| Depreciation and amortization             | 1,639                        |             |                   | 1,639          |
| Total expenses                            | 38,318                       |             | 263               | 38,581         |
| Operating income (loss)                   | 3,781                        | (1,334)     |                   | 2,447          |
| Other income (expense):                   |                              |             |                   |                |
| Interest income                           | 402                          |             |                   | 402            |
| Interest expense                          | (174)                        |             |                   | (174)          |
| Gain on interest rate derivative contract | 192                          |             |                   | 192            |
| Other income                              | 36                           |             |                   | 36             |
| Total other income                        | 456                          |             |                   | 456            |
| Income (loss) before income tax provision | 4,237                        | (1,334)     |                   | 2,903          |
| Income tax provision                      | (1,899)                      | 534         |                   | (1,365)        |
| Net income                                | 2,338                        | (800)       |                   | 1,538          |
| Net income per share basic                | \$ 0.07                      | \$ (0.02)   | \$                | \$ 0.05        |
| Net income per share diluted              | \$ 0.07                      | \$ (0.02)   | \$                | \$ 0.04        |

Weighted average shares used in computing net income per share:

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|         |        |        |        |        |
|---------|--------|--------|--------|--------|
| Basic   | 33,418 | 33,418 | 33,418 | 33,418 |
| Diluted | 34,814 | 34,814 | 34,814 | 34,814 |
|         | 6      |        |        |        |

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**Table of Contents****athenahealth, Inc.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited amounts in thousands, except per-share amounts)***Condensed Consolidated Statement of Cash Flows Impact*

The following table includes selected information from our condensed consolidated statements of cash flows presenting previously reported and restated cash flows, for the three months ended March 31, 2009:

|   | <b>For the three months ended<br/>March 31, 2009</b> |                        |
|---|--|------------------------|
|   | <b>As</b>  |                        |
|   | <b>Previously<br/>Reported</b>                       | <b>As<br/>Restated</b> |
| Net income  | \$ 2,338   | \$ 1,538               |
| Deferred income taxes (1)   | 1,899  | 1,365                  |
| Deferred revenue (1)  | (116)  | 1,218                  |
| Proceeds from the sales and disposals of property and equipment (2) |  | 1,803                  |
| Net cash provided by (used in) investing activities                 | (13,521)   | (11,718)               |
| Proceeds from long-term debt and capital lease obligations (2)      | 1,803  |                        |
| Net cash provided by financing activities                           | 690  | (1,113)                |

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

(2) To correct the presentation of draw downs of capital lease obligations.

**3. RECENT ACCOUNTING PRONOUNCEMENTS**

In October 2009, the FASB issued authoritative guidance on revenue recognition that will become effective for the Company beginning January 1, 2011, with earlier adoption permitted. Under the new guidance on arrangements that include software elements, tangible products that have software components that are essential to the functionality of the tangible product will no longer be within the scope of the software revenue recognition guidance, and software-enabled products will now be subject to other relevant revenue recognition guidance. Additionally, the FASB issued authoritative guidance on revenue arrangements with multiple deliverables that are outside the scope of the software revenue recognition guidance. Under the new guidance, when vendor specific objective evidence or third party evidence for deliverables in an arrangement cannot be determined, a best estimate of the selling price is required to separate deliverables and allocate arrangement consideration using the relative selling price method. The new guidance includes new disclosure requirements on how the application of the relative selling price method affects the timing and amount of revenue recognition. The Company is currently evaluating the impact of adoption of this authoritative guidance might have on our financial statements, if any.

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



**Table of Contents****athenahealth, Inc.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited amounts in thousands, except per-share amounts)****4. NET INCOME PER SHARE**

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

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

|  | Three Months<br>Ended<br>March 31,<br>2010 | Three Months<br>Ended<br>March 31,<br>2009 |
|--|--|--|
| Net income   | \$ 277                                     | \$ 1,538                                   |
| Weighted average shares used in computing basic net income per share   | 34,014                                     | 33,418                                     |
| Net income per share basic   | \$ 0.01                                    | \$ 0.05                                    |
| Net income   | \$ 277                                     | \$ 1,538                                   |
| Weighted average shares used in computing basic net income per share   | 34,014                                     | 33,418                                     |
| Effect of dilutive securities  | 1,187                                      | 1,396                                      |
| Weighted average shares used in computing diluted net income per share | 35,201                                     | 34,814                                     |
| Net income per share diluted   | \$ 0.01                                    | \$ 0.04                                    |

The computation of diluted net income per share does not include 963 and 1,916 options for the three months ended March 31, 2010, and March 31, 2009, respectively, because their inclusion would have an antidilutive effect on net income per share.

**5. COMPREHENSIVE INCOME**

Comprehensive income was as follows for the periods indicated:

|   | Three Months<br>Ended<br>March 31,<br>2010 | Three Months<br>Ended<br>March 31,<br>2009 |
|---|--|--|
| Net income  | \$ 277                                     | \$ 1,538                                   |
| Unrealized holding loss on available-for-sale investments | (55)                                       | (62)                                       |
| Foreign currency translation adjustment                   | 17   | 3  |

|                            |    |     |    |       |
|----------------------------|----|-----|----|-------|
| Total comprehensive income | \$ | 239 | \$ | 1,479 |
|----------------------------|----|-----|----|-------|

#### 6. FAIR VALUE OF FINANCIAL INSTRUMENTS

As of March 31, 2010 and December 31, 2009, the carrying amounts of cash and cash equivalents, restricted cash, receivables, accounts payable, and accrued expenses approximated the estimated fair values because of their short-term nature of these financial instruments. All highly liquid debt instruments purchased with a maturity of three months or less at the date of acquisition are included in cash and cash equivalents. Included in cash and cash equivalents as of March 31, 2010 and December 31, 2009, are money market fund investments of \$6,249 and \$10,081, respectively, which are reported at fair value.

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

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

The following table presents information about the Company's financial assets and liabilities that are measured at fair value on a recurring basis as of March 31, 2010 and December 31, 2009, and indicates the fair value hierarchy of the valuation techniques the Company utilized to determine such fair value. In general, fair values determined by Level 1 inputs utilize quoted prices (unadjusted) in active markets for identical assets or liabilities and fair values determined by Level 2 inputs utilize quoted prices (unadjusted) in inactive markets for identical assets or liabilities obtained from readily available pricing sources for comparable instruments or quoted prices for similar instruments in active markets when available. The fair values determined by Level 3 inputs are unobservable values which are supported by little or no market activity.

|                                   | <b>Fair Value Measurements At March 31, 2010,</b> |                          |                |              |
|-----------------------------------|---|--------------------------|----------------|--------------|
|                                   | <b>Level 1</b>                                    | <b>Using<br/>Level 2</b> | <b>Level 3</b> | <b>Total</b> |
| Cash and cash equivalents:        |   |                          |                |              |
| Money market                      | \$ 6,249  | \$                       | \$             | \$ 6,249     |
| Available-for-sale investments:   |   |                          |                |              |
| Commerical paper                  |   | 5,497                    |                | 5,497        |
| Corporate bonds                   |   | 22,006                   |                | 22,006       |
| U.S. government backed securities |   | 31,325                   |                | 31,325       |
| Accrued contingent consideration  |   |                          | (5,404)        | (5,404)      |
| Interest rate derivative contract |   | (351)                    |                | (351)        |
| Total short-term investments      | \$ 6,249  | \$ 58,477                | \$ (5,404)     | \$ 59,322    |

|                                   | <b>Fair Value Measurements as of December 31,</b> |                                |                |              |
|-----------------------------------|---|--------------------------------|----------------|--------------|
|                                   | <b>Level 1</b>                                    | <b>2009, Using<br/>Level 2</b> | <b>Level 3</b> | <b>Total</b> |
| Cash and cash equivalents:        |   |                                |                |              |
| Money market                      | \$ 10,081   | \$                             | \$             | \$ 10,081    |
| Available-for-sale investments:   |   |                                |                |              |
| U.S. government backed securities |   | 52,323                         |                | 52,323       |
| Accrued contingent consideration  |   |                                | (5,100)        | (5,100)      |
| Interest rate derivative contract |   | (291)                          |                | (291)        |
| Total short-term investments      | \$ 10,081   | \$ 52,032                      | \$ (5,100)     | \$ 57,013    |

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

It is the Company's policy to recognize transfers between levels of the fair value hierarchy, if any, at the end of the reporting period however there have been no such transfers during the three months ended March 31, 2010.

The fair value of the accrued contingent consideration was determined using a probability-weighted income approach at the acquisition date and reporting date. That approach is based on significant inputs that are not observable in the market, which are referred to as Level 3 inputs. Key assumptions include a discount rate of 21% and a probability adjusted level of 60%. As of March 31, 2010, the Company has accrued a liability of \$5,404 for the

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estimated fair value of contingent considerations expected to be payable upon the acquired company reaching specific performance metrics over the next three years of operation. As of March 31, 2010, the ranges of outcomes and key assumptions have not changed.

|  |          |
|--|----------|
| Accrued contingent consideration balance as of January 1, 2010 | \$ 5,100 |
| Increase in fair value of contingent consideration             | 304      |
| Accrued contingent consideration balance as of March 31, 2010  | \$ 5,404 |

**Table of Contents****athenahealth, Inc.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited amounts in thousands, except per-share amounts)****7. INVESTMENTS**

The summary of available-for-sale securities as of March 31, 2010, is as follows:

|                                   | <b>Amortized<br/>Cost</b> |    | <b>Gross Unrealized<br/>Gains (Loss)</b> |    | <b>Fair<br/>Value</b> |
|-----------------------------------|---------------------------|----|--|----|-----------------------|
| Commercial paper                  | \$ 5,494                  | \$ | 3  | \$ | 5,497                 |
| Corporate bonds                   | 22,034                    |    | (28)                                     |    | 22,006                |
| U.S. government backed securities | 31,311                    |    | 14                                       |    | 31,325                |
| Total                             | \$ 58,839                 | \$ | (11)                                     | \$ | 58,828                |

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

|                                   | <b>Amortized<br/>Cost</b> |    | <b>Gross Unrealized<br/>Gains</b> |    | <b>Fair<br/>Value</b> |
|-----------------------------------|---------------------------|----|-----------------------------------|----|-----------------------|
| U.S. government backed securities | \$ 52,280                 | \$ | 43                                | \$ | 52,323                |

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

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

|  | <b>As of March<br/>31,<br/>2010</b> |    | <b>As of December<br/>31,<br/>2009</b> |
|--|-------------------------------------|----|--|
| Term loan  | \$ 5,550                            | \$ | 5,625                                  |
| Capital lease obligation   | 6,313                               |    | 6,763                                  |
|  |                                     |    | 11,863                                 |
| Less current portion of long-term debt and capital lease obligations |                                     |    | (3,440)                                |
| Long-term debt and capital lease obligations, net of current portion | \$ 8,423                            | \$ | 8,951                                  |

*2008 Term and Revolving Loans* On September 30, 2008, the Company entered into a Credit Agreement (the Credit Agreement ) with a financial institution. The Credit Agreement consists of a revolving credit facility in the amount of \$15,000 and a term loan facility in the amount of \$6,000 (collectively, the Credit Facility ). The revolving credit facility may be extended by an additional \$15,000 on the satisfaction of certain conditions and includes a \$10,000 sublimit for the issuance of standby letters of credit. The revolving credit facility matures on September 30, 2011, and the term facility matures on September 30, 2013, although either facility may be voluntarily prepaid in whole or in part at any time without premium or penalty. As of March 31, 2010, there were no amounts outstanding under the revolving credit facility. On September 30, 2008, the Company borrowed a total of \$6,000 under the term loan facility for general working capital purposes. The term loan has a 5 year term which is payable quarterly starting December 31, 2008, for \$75 each quarter. The Company has the option to extend the loan, subject to agreement of the lender, at the end of the 5 year term.

The revolving credit loan and term loan bear interest, at the Company's option, at either (i) the financial institution's London Interbank Offered Rate (LIBOR), or (ii) the higher of (a) the Federal Funds Rate plus 0.50% or (b) the financial institution's prime rate (the higher of the two being the Base Rate). For term loans, these rates are adjusted down 100 basis points for Base Rate loans and up 100 basis points for LIBOR loans. For revolving credit loans, a margin is added to the chosen interest rate that is based on the Company's consolidated leverage ratio, as defined in the Credit Agreement, which margin can range from 100 to 275 basis points for LIBOR loans and from 0 to 50 basis points for Base Rate loans. A default rate shall apply on all obligations in the event of a default under the Credit Agreement at a rate per annum equal to 2% above the applicable interest rate. The Company was also required to pay commitment fees and upfront fees for this Credit Facility. The interest rate as of March 31, 2010, and December 31, 2009, for the term loan was 4.5%.

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

The Credit Agreement also contains certain financial and nonfinancial covenants, including limitations on our consolidated leverage ratio and capital expenditures, defaults relating to non-payment, breach of covenants, inaccuracy of representations and warranties, default under other indebtedness (including a cross-default with our interest rate swap), bankruptcy and insolvency, inability to pay debtors, attachment of assets, adverse judgments, ERISA violations, invalidity of loan and collateral documents, payments of dividends, and change of control. Upon an event of default, the lenders may terminate the commitment to make loans and

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

the obligation to extend letters of credit, declare the unpaid principal amount of all outstanding loans and interest accrued under the Credit Agreement to be immediately due and payable, require us to provide cash and deposit account collateral for our letter of credit obligations, and exercise their security interests and other rights under the credit agreement.

*Capital Lease Obligations* In June 2007, the Company entered into a master lease and security agreement (the Equipment Line ) with a financing company. The Equipment Line allows for the Company to lease from the financing company eligible equipment purchases, submitted within 90 days of the applicable equipment's invoice date. Each lease has a 36 month term which is payable in equal monthly installments, commencing on the first day of the fourth month after the date of the disbursements of such loan and continuing on the first day of each month thereafter until paid in full. The Company has accounted for these as capital leases. At March 31, 2010 and December 31, 2009, the Company had \$6,313 and \$6,763, respectively, of outstanding capital leases. The weighted average interest rate implicit in the leases was 4.4%.

**9. INTEREST RATE SWAP**

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

The swap had a notional amount of \$5,850 to hedge changes in cash flows attributable to changes in the LIBOR rate associated with the September 30, 2008, issuance of the Term Loan due September 30, 2028. We pay a fixed rate of 4.55% and receive a variable rate based on one month LIBOR. The fair value of derivatives as of March 31, 2010, is summarized in the following table.

|                                   | Liability Derivatives<br>Balance Sheet Location | Fair Value |
|-----------------------------------|---|------------|
| Interest rate derivative contract | Interest rate derivative liability              | \$ 351     |
| Total Derivative                  |   | \$ 351     |

The effect of derivative instruments on the consolidated statement of earnings is summarized in the following table.

|  | (Loss)<br>Recognized in<br>Earnings for<br>Three<br>Months<br>Ended<br>March 31,<br>2010 | Gain<br>Recognized in<br>Earnings for<br>Three<br>Months<br>Ended<br>March 31,<br>2009 |
|--|--|--|
| Location of (Loss) Gain<br>Recognized in Earnings<br>(Loss) gain on interest rate<br>derivative contract | Months Ended<br>March 31,<br>2010  | Months<br>Ended<br>March 31,<br>2009   |
| Interest rate contracts  | \$ (60)  | \$ 192   |

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

| Description                                | Underlying            | Remaining          |               | Pay            | Fiscal<br>Year<br>Entered<br>Into | Maturity<br>(Fiscal<br>Year) | Fair Value<br>at<br>March 31,<br>2010 |
|--|-----------------------|--------------------|---------------|----------------|-----------------------------------|------------------------------|---------------------------------------|
|  |                       | Notional<br>Amount | Receive       |                |                                   |                              |                                       |
| Interest rate<br>swap variable<br>to fixed | Interest on Term Loan | \$5,550            | LIBOR plus 1% | 4.55%<br>fixed | 2008                              | 2028                         | \$ (351)                              |

**10. STOCK-BASED COMPENSATION***Employee Stock Purchase Plan*

In 2007, our 2007 Employee Stock Purchase Plan ( 2007 ESPP ) was adopted by the Board of Directors and approved by the Company's shareholders. A total of 500 shares of common stock have been reserved for future issuance to participating employees



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

under the 2007 ESPP. The initial offering period under the 2007 ESPP began March 1, 2008, and each offering period is six months. The expense to the Company for the three months ended March 31, 2010, and 2009, was \$66 and \$97, respectively. Cash received from employee stock purchase plan issuances during the quarters ended March 31, 2010 and 2009, was \$470 and \$304, respectively.

*Stock Option Plan*

The Company's stock award plans provide the opportunity for employees, consultants, and directors to be granted options to purchase, receive awards, or make direct purchases of shares of the Company's common stock. In 2007, the Board of Directors and the Company's shareholders approved the 2007 Stock Option and Incentive Plan (the "2007 Stock Option Plan"), effective as of the close of our initial public offering, which occurred on September 25, 2007. The Board of Directors authorized 1,000 shares in addition to any shares forfeited under our 2000 Stock Option Plan. Options granted under the plan may be incentive stock options or nonqualified stock options under the applicable provisions of the Internal Revenue Code. The 2007 Stock Option Plan also allows for granting of restricted stock unit awards under the terms of the plan. The 2007 Stock Option Plan includes an "evergreen provision" that allows for an annual increase in the number of shares of common stock available for issuance under the 2007 Stock Option Plan. On January 1, 2010, under the "evergreen provision" of the 2007 Stock Option Plan, an additional 995 shares were made available for future grant under the 2007 Stock Option Plan.

At March 31, 2010, and 2009, there were approximately 1,936 and 1,340 shares available for grant under all the Company's stock award plans.

The following table presents the stock option activity for the three months ended March 31, 2010:

|  | Shares | Weighted-Average<br>Exercise<br>Price | Weighted-Average<br>Remaining<br>Contractual<br>Term (in years) | Aggregate<br>Intrinsic<br>Value |
|--|--------|---------------------------------------|---|---------------------------------|
| Outstanding January 1, 2010  | 3,432  | \$ 21.62                              |   |                                 |
| Granted  | 223    | \$ 43.02                              |   |                                 |
| Exercised  | (169)  | \$ 16.59                              |   |                                 |
| Forfeited  | (53)   | \$ 28.05                              |   |                                 |
| Outstanding at March 31, 2010  | 3,433  | \$ 23.15                              | 7.6   | \$ 48,127                       |
| Exercisable at March 31, 2010  | 1,729  | \$ 15.14                              | 6.5   | \$ 37,103                       |
| Vested and expected to vest at March 31, 2010  | 3,227  | \$ 22.59                              | 7.6   | \$ 46,870                       |
| Weighted-average fair value of options granted for the three months ended March 31, 2010 |        | \$ 22.47                              |   |                                 |

The aggregate intrinsic value in the table above represents the value (the difference between the closing price for the Company's common stock on March 31, 2010, and the exercise price of the options, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on March 31, 2010.

The Company recorded total stock-based compensation expense of \$2,784 and \$1,916 for the three months ended March 31, 2010 and 2009, respectively.

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

|                              | Three Months ended March 31, |             |
|------------------------------|------------------------------|-------------|
|                              | 2010                         | 2009        |
| Risk-free interest rate      | 2.75% - 3.0%                 | 1.9% - 2.2% |
| Expected dividend yield      | 0.0%                         | 0.0%        |
| Expected option term (years) | 6.25                         | 6.25        |
| Expected stock volatility    | 50% to 52%                   | 49.0%       |

The risk-free interest rate estimate was based on the U.S. Treasury rates for U.S. Treasury zero-coupon bonds with maturities similar to those of the expected term of the award being valued.

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The expected dividend yield was based on our expectation of not paying dividends in the foreseeable future. The weighted average expected option term reflects the application of the simplified method. The simplified method defines the life as the average of the contractual term of the options and the weighted average vesting period for all option tranches. In December 2007, the SEC issued additional guidance, which permits entities, under certain circumstances, to continue to use the simplified method beyond December 31, 2007. We have continued to utilize this methodology for the three months ended March 31, 2010, due to the short length of time our common stock has been publicly traded. The resulting fair value is recorded as compensation cost on a straight-line basis over the requisite service period, which generally equals the option vesting period. Since the Company completed its initial public offering in September 2007, it did not have sufficient history as a publicly traded company to evaluate its volatility factor and expected term. As such, we analyzed the volatilities of a group of peer companies to support the assumptions used in its calculations. We averaged the volatilities of the peer companies with in-the-money options, sufficient trading history and similar vesting terms to generate the assumptions.

At March 31, 2010 and 2009, there was \$29,047 and \$28,175, respectively, of unrecognized stock-based compensation expense related to unvested share-based compensation arrangements granted under the Company's stock award plans. This expense is expected to be recognized over a weighted-average period of approximately 2.75 years.

Cash received from stock option exercises during the quarters ended March 31, 2010 and 2009, was \$2,799 and \$226, respectively. The intrinsic value of the shares issued from option exercises in the quarters ended March 31, 2009 and 2008, was \$4,457 and \$3,225, respectively, and represents the difference between the exercise price of the option and the market price of the Company's common stock on the dates exercised. The weighted-average grant date fair value of options granted during the three months ended March 31, 2010, and 2009 was \$22.47 and \$12.99, respectively. The Company generally issues previously unissued shares for the exercise of stock options, however the Company may reissue previously acquired treasury shares to satisfy these issuances in the future.

*Restricted Stock Units*

The 2007 Stock Option Plan also allows for granting of restricted stock unit awards under the terms of the plan. Such restricted units vest in four equal, annual installments on the anniversaries of the vesting start date. The Company estimated the fair value of the restricted stock units using the market price of its common stock on the date of the grant. The weighted-average grant date fair value of restricted stock units granted during the three months ended March 31, 2010 was \$40.90. The fair value of restricted stock units is amortized on a straight-line basis over the vesting period. As of March 31, 2010, 40 restricted units were granted and \$85 of compensation expense was recorded for restricted stock units during the three months ended March 31, 2010.

As of March 31, 2010, \$1,547 of total unrecognized compensation costs related to restricted stock units is expected to be recognized over a weighted average period of 3.8 years. This amount does not include the cost of new restricted stock units that may be granted in future periods or any changes in the Company's forfeiture percentage. During the three months ended March 31, 2010, no restricted stock units became vested. There were no restricted stock units outstanding during the three months ended March 31, 2009.

*Summary of Stock-Based Compensation Expense*

Stock-based compensation expense for the three months ended March 31, 2010 and 2009, are as follows (no amounts were capitalized):

|  | Three months ended March<br>31, |        |
|--|---------------------------------|--------|
|  | 2010                            | 2009   |
| Stock-based compensation expense charged to: |                                 |        |
| Direct operating                             | \$ 468                          | \$ 375 |
| Selling and marketing                        | 690                             | 514    |
| Research and development                     | 324                             | 243    |

|                            |          |          |
|----------------------------|----------|----------|
| General and administrative | 1,302    | 784      |
| Total                      | \$ 2,784 | \$ 1,916 |

**11. INCOME TAXES**

The provision for income taxes represents the Company's federal and state income tax obligations as well as foreign tax provisions. The Company's provision for income taxes was \$281 and \$1,365 for the three months ended March 31, 2010 and 2009,

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

respectfully. The Company used an estimated annual effective tax rate of 46% and 47% to calculate the quarterly tax provision for the three months ended March 31, 2010, and 2009, respectively, (discrete items were taxed separately at the statutory federal and blended state rate, net of federal benefit). Management is required to estimate the annual effective tax rate based upon its forecast of annual pre-tax income. To the extent that actual pre-tax results for the year differ from the forecast estimates applied at the end of the most recent interim period, the actual tax rate recognized in fiscal year 2010 could be materially different from the forecasted rate.

The Company's policy is to record interest and penalties related to unrecognized tax benefits in income tax expense. As of March 31, 2010, interest or penalties related to uncertain tax positions accrued by the Company was not material. The Company files U.S., state and foreign income returns in jurisdictions with varying statutes of limitation. The Company's primary state jurisdiction is the Commonwealth of Massachusetts. The Company is under corporate excise tax audit in Massachusetts for fiscal years 2006 through 2008. At the time of this filing, the Company has not received any indication on audit related adjustments. The Internal Revenue Service ( IRS ) has audited the Company's federal income tax filings through fiscal year 2008.

**12. COMMITMENTS AND CONTINGENCIES**

On March 2, 2010, a complaint was filed by *Prompt Medical Systems, L.P.* naming the Company and several other defendants in a patent infringement case (*Prompt Medical Systems, L.P. v. AllscriptsMisys Healthcare Solutions, Inc. et al*, Civil Action No. 6:2010cv00071, United States District Court for the Eastern District of Texas). The complaint alleges that we have infringed on a patent with a listed issue date in 1996 entitled "Method for Computing Current Procedural Terminology Codes from Physician Generated Documentation" and seeks an injunction enjoining infringement, damages, and pre- and post-judgment costs and interest. At this time, we have been served with process in connection with this case, and a response to the complaint is currently due by May 26, 2010. We believe that we have meritorious defenses to the complaint, and we will contest the claims vigorously.

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

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

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

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

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

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

**Restatement**

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

- (1) Our consolidated statements of operations for the three months ended March 31, 2009, and the related cash flows for the three months ended March 31, 2009 located in Part I, Item 1 of this Quarterly Report on Form 10-Q; and
- (2) Our management's discussion and analysis of financial condition and results of operations as of and for the three months ended March 31, 2009, contained herein;

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

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

**Overview**

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

record, or EHR, platform. ReminderCall, which we added to our service suite in September 2008, is our automated appointment reminder system that allows patients to either confirm the appointment or request rescheduling. We have now combined ReminderCall with other automated patient messaging services, live operator services, and a patient web portal in the first edition of our athenaCommunicator services suite that we beta launched in 2009 and made commercially available on March 17,

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2010. We refer to athenaCollector as our revenue cycle management service, athenaClinical as our clinical cycle management service, and athenaCommunicator as our patient cycle management service. As a complement to these services, Anodyne Analytics, is a web-based, Software-as-a-Service business intelligence platform that organizes and displays detailed and insightful practice performance data for decision makers at our client practices. Our services are designed to help our clients achieve faster reimbursement from payers, reduce error rates, increase collections, lower operating costs, improve operational workflow controls, improve patient satisfaction and compliance, and more efficiently manage clinical and billing information.

For the three months ended March 31, 2010, we generated revenue of \$54.5 million from the sale of our services compared to \$41.0 million for the three months ended March 31, 2009. In 2009, we generated revenue of \$188.5 million from the sale of our services compared to \$136.3 million in 2008. Given the scope of our market opportunity, we have increased our spending each year on growth, innovation, and infrastructure. Despite increased spending in these areas, higher revenue and lower operating expenses as a percentage of revenue have typically lead to greater operating income. However, the reversal of a valuation allowance against deferred tax assets that occurred in the fourth quarter of 2008 has had and will have an impact on net profits as our results are now fully taxed.

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

**Critical Accounting Policies**

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

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

**Financial Operations Overview**



*Revenue.* We derive our revenue from two sources: from business services associated with our revenue cycle, clinical cycle, patient cycle and Anodyne Analytics offerings and from implementation and other services. Implementation and other revenue consist primarily of professional services fees related to assisting clients with the initial implementation of our services and for ongoing training and related support services. Business services accounted for approximately 96% and 97% of our total revenues for the three months ended March 31, 2010 and 2009, respectively. Business services revenue is typically 2% to 8% of a practice's total collections depending upon the services purchased, the size, complexity, and other characteristics of the practice, plus a per-statement charge for billing statements that are generated for patients. Accordingly, business services revenue is largely driven by: the number of physician practices and other service providers we serve, the number of physicians and other medical providers working in those physician practices, the volume of activity and related collections of those physicians, the mix of our services used by those physician practices, and other medical providers, and our contracted rates. We expect to increase the number of physician practices we serve through increased sales and marketing expense, and we expect our existing clients to use more of our services through cross-selling efforts and growth in the number of combined services sales. There is moderate seasonality in the activity level of physician practices.

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Typically, discretionary use of physician services declines in the late summer and during the holiday season, which leads to a decline in collections by our physician clients about 30 to 50 days later. Additionally, the volume of activity and related collections vary from year to year based in large part on the severity, length and timing of the onset of the flu season. While we believe that the severity, length and timing of the onset of the cold and flu season will continue to impact collections by our physician clients, as would other seasonal or pandemic illnesses, there can be no assurance that our future sales of these products will necessarily follow historical patterns. Implementation revenue and other revenue are largely driven by the increase in the volume of our new business. As a result, we expect implementation and other revenue to increase in absolute terms for the foreseeable future but to remain relatively consistent as a percentage of total revenue. None of our clients accounted for more than 10% of our total revenues for the three months ended March 31, 2010, and March 31, 2009.

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

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

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

*General and Administrative Expense.* General and administrative expense consists primarily of personnel-related expense for administrative employees (including salaries, benefits, stock-based compensation, non-billable travel, lodging, and other out-of-pocket employee-related expense), occupancy and other indirect costs (including building maintenance and utilities), and insurance premiums; software license fees; outside professional fees for accountants, lawyers, and consultants; and compensation for temporary employees. We expect that general and administrative

expense will increase in absolute terms as we invest in infrastructure to support our growth and incur additional expense related to being a publicly traded company and our restatement. Though expenses are expected to continue to rise in absolute terms, we expect general and administrative expense to decline as a percentage of total revenues.

*Depreciation and Amortization Expense.* Depreciation and amortization expense consists primarily of depreciation of fixed assets and amortization of capitalized software development costs, which we amortize over a two-year period from the time of release of related software code. As we grow, we will continue to make capital investments in the infrastructure of the business and we will continue to develop software that we capitalize. At the same time, because we are spreading fixed costs over a larger client base, we expect related depreciation and amortization expense to decline as a percentage of total revenues over time.

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

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designated for hedge accounting, we believe that such instrument is correlated with the underlying cash flow exposure related to variability in interest rate movements on our term loan.

**Results of Operations***Comparison of the Three Months Ended March 31, 2010 and 2009*

|                          | <b>Three Months Ended March<br/>31,</b> |                        | <b>Change</b> |                |
|--------------------------|---|------------------------|---------------|----------------|
|                          | <b>Amount<br/>2010</b>                  | <b>Amount<br/>2009</b> | <b>Amount</b> | <b>Percent</b> |
|                          | (in thousands)                          |                        |               |                |
| Business services        | \$ 52,565                               | \$ 39,895              | \$ 12,670     | 32%            |
| Implementation and other | 1,912                                   | 1,133                  | 779           | 69%            |
| Total                    | \$ 54,477                               | \$ 41,028              | \$ 13,449     | 33%            |

*Revenue.* Total revenue for the three months ended March 31, 2010, was \$54.5 million, an increase of \$13.5 million, or 33%, over revenue of \$41.0 million for the three months ended March 31, 2009. This increase was due almost entirely to an increase in business services revenue.

*Business Services Revenue.* Revenue from business services for the three months ended March 31, 2010, was \$52.6 million, an increase of \$12.7 million, or 32%, over revenue of \$39.9 million for the three months ended March 31, 2009. This increase was primarily due to the growth in the number of physicians and other medical providers using our services. The number of physicians using our services at March 31, 2010, was 16,369, a net increase of 3,173 or 24%, from 13,196 physicians at March 31, 2009. The number of active medical providers using our services at March 31, 2010, was 23,978, a net increase of 4,239 or 21%, from 19,739 active medical providers at March 31, 2009. Also contributing to this increase was the growth in related collections on behalf of these physicians and other medical providers. The amount of collections processed for the three months ended March 31, 2010, was \$1,313 million, an increase of \$227 million, or 21%, over posted collections of \$1,086 million for the three months ended March 31, 2009.

*Implementation and Other Revenue.* Revenue from implementations and other sources was \$1.9 million for the three months ended March 31, 2010, an increase of \$0.8 million, or 69%, over revenue of \$1.1 million for the three months ended March 31, 2009. This increase was driven by new client implementations and increased professional services for our larger client base. As of March 31, 2010, the numbers of accounts live on our revenue cycle management service, athenaCollector, increased by 351 accounts since March 31, 2009 to 1,684. As of March 31, 2010, the number of accounts live on our clinical cycle management service, athenaClinicals, increased by 127 accounts since March 31, 2009. The increase in implementation and other revenue is the result of the increase in the volume of our business.

|                        | <b>Three Months Ended March<br/>31,</b> |                        | <b>Change</b> |                |
|------------------------|---|------------------------|---------------|----------------|
|                        | <b>2010<br/>Amount</b>                  | <b>2009<br/>Amount</b> | <b>Amount</b> | <b>Percent</b> |
|                        | (in thousands)                          |                        |               |                |
| Direct operating costs | \$ 23,519                               | \$ 18,561              | \$ 4,958      | 27%            |

*Direct Operating Costs.* Direct operating expense for the three months ended March 31, 2010, was \$23.5 million, an increase of 27% over costs of \$18.6 million for the three months ended March 31, 2009. This increase was primarily due to an increase in the number of claims that we processed on behalf of our clients and the related expense of providing services, including transaction expenses and employee-related costs. The amount of collections processed for the three months ended March 31, 2010, was \$1,313 million, an increase of \$227 million, or 21%, over posted collections of \$1,086 million for the three months ended March 31, 2009. Direct operating employee-related costs

increased \$2.7 million from the three months ended March 31, 2009 to the three months ended March 31, 2010. This increase is primarily due to the 15% increase in headcount since March 31, 2009. We increased the professional services headcount in order to meet the current and anticipated demand for our services as our customer base and service offering has expanded to include larger medical groups. For the three months ended March 31, 2010, direct operating expense includes \$0.5 million of amortization of purchased intangibles expense related to the purchase of certain assets through acquisitions completed in 2009 and 2008 compared to less than \$0.1 million in the three months ended March 31, 2009. Stock Compensation expense also increased \$0.1 million from the three months ended March 31, 2009 to the three months ended March 31, 2010.

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|                               | <b>Three Months Ended March<br/>31,</b> |                        |                  |                |
|-------------------------------|---|------------------------|------------------|----------------|
|                               | <b>2010<br/>Amount</b>                  | <b>2009<br/>Amount</b> | <b>Change</b>    |                |
|                               | (in thousands)                          |                        |                  |                |
|                               | <b>Amount</b>                           | <b>Amount</b>          | <b>Amount</b>    | <b>Percent</b> |
| Selling and marketing         | \$ 12,060                               | \$ 6,999               | \$ 5,061         | 72%            |
| Research and development      | 4,074                                   | 3,181                  | 893              | 28%            |
| General and administrative    | 11,677                                  | 8,201                  | 3,476            | 42%            |
| Depreciation and amortization | 2,420                                   | 1,639                  | 781              | 48%            |
| <b>Total</b>                  | <b>\$ 30,231</b>                        | <b>\$ 20,020</b>       | <b>\$ 10,211</b> | <b>51%</b>     |

*Selling and Marketing Expense.* Selling and marketing expense for the three months ended March 31, 2010, was \$12.1 million, an increase of \$5.1 million, or 72%, over costs of \$7.0 million for the three months ended March 31, 2009. This increase was primarily due to an increase in stock-based compensation expense of \$0.2 million, an increase in employee-related costs and sales commission of \$2.3 million due to an increase in headcount, \$0.2 million increase in travel related expenses and \$2.4 million in other marketing related expenses related to online and offline marketing, consulting and external partner commission. Our marketing and sales headcount increased by 57% since March 31, 2009, as we hired additional sales personnel to focus on adding new customers, marketing new services, and increasing penetration within our existing markets.

*Research and Development Expense.* Research and development expense for the three months ended March 31, 2010, was \$4.1 million, an increase of \$0.9 million, or 28%, over research and development expense of \$3.2 million for the three months ended March 31, 2009. This increase was primarily due to a \$0.9 million increase in employee-related costs due to an increase in headcount. Our research and development headcount increased 34% since March 31, 2009, as we hired additional research and development personnel in order to upgrade and extend our service offerings and develop new technologies.

*General and Administrative Expense.* General and administrative expense for the three months ended March 31, 2010, was \$11.7 million, an increase of \$3.5 million, or 42%, over general and administrative expenses of \$8.2 million for the three months ended March 31, 2009. This increase was primarily due to a \$1.0 million increase in employee-related costs due to an increase in headcount and an increase in stock compensation expense of \$0.6 million. Our general and administrative headcount increased by 16% since March 31, 2009, as we added personnel to support our growth. Legal, audit, insurance and consulting expenses also increased \$0.6 million primarily due to additional costs related to being a public company and \$1.0 million in additional costs relating to our restatement. Additionally, under new authoritative guidance on business combinations adopted January 1, 2009, any changes in the fair value of contingent consideration after the acquisition date affect earnings. The potential contingent consideration of \$7,700 was recorded in the initial purchase price allocation at its estimated fair value of \$5,100. A portion of the contingent consideration relating to the Anodyne acquisition expected to be paid in 2011 and 2012 totaling \$787 and is presented in other long-term liabilities. The contingent consideration will be adjusted to fair value to the amount payable when, and if, earned. The difference between the estimated and earn-out amount will be charged or credited to expense. For the three months ended March 31, 2010, approximately \$0.3 million was expensed relating to this contingent consideration.

*Depreciation and Amortization.* Depreciation and amortization expense for the three months ended March 31, 2010, was \$2.4 million, an increase of \$0.8 million, or 48%, over depreciation and amortization expense of \$1.6 million for the three months ended March 31, 2009. This was primarily due to higher depreciation from fixed asset expenditures in 2010 and 2009.

*Other Income (Expense).* Interest income for the three months ended March 31, 2010, was \$0.1 million, a decrease of \$0.3 million from interest income of \$0.4 million for the three months ended March 31, 2009. The decrease was

directly related to the lower interest rates during 2010 and due to a lower cash balance due to the cash paid for an acquisition of \$30 million in the fourth quarter of 2009. Interest expense for the three months ended March 31, 2010, and 2009 was \$0.2 million for each period. The loss on interest rate derivative for the three months ended March 31, 2010, was less than \$0.1 million, compared to a gain on interest rate derivative for the three months ended March 31, 2009, was \$0.2 million. The gain or loss on the interest rate derivative was the result of the change in the fair market value of a derivative instrument that was not designated a hedge. Although this derivative does not qualify for hedge accounting, we believe that the instrument is closely correlated with the underlying exposure, thus managing the associated risk. The gains or losses from changes in the fair value of derivative instruments that are not accounted for as hedges are recognized in earnings.

*Income Tax Provision.* We recorded a provision for income taxes for the three months ended March 31, 2010, of approximately \$0.3 million compared to \$1.4 million for the three months ended March 31, 2009. We have provided income tax expense for the three months ended March 31, 2010 and 2009, using the expected effective tax rate for the entire year of 46% and 47%, respectively.

**Table of Contents****Liquidity and Capital Resources**

Although we have historically funded our operations through the private and public sale of \$131.9 million in equity securities, as well as through long-term debt, working capital, and equipment-financing loans, our recent growth has been sustained by our continued profitability since the third quarter of 2007. As of March 31, 2010, our principal sources of liquidity were cash and cash equivalents and short-term investments totaling \$79.1 million. Our total indebtedness was \$11.9 million at March 31, 2010, and was comprised of capital lease obligations of \$6.3 million and a term loan of \$5.6 million.

Cash provided by operating activities during the three months ended March 31, 2010, was \$1.1 million and consisted of net income of \$0.3 million and \$5.9 million utilized by working capital and other activities. Cash provided by operating activities included positive non-cash adjustments of \$2.9 million related to depreciation and amortization expense, a \$2.8 million non-cash stock-based compensation expense, a \$0.3 million non-cash expense for the change in the fair value of contingent consideration, a \$0.4 million amortization of premiums on investments, a \$0.1 million non-cash loss on interest rate derivative, and \$0.2 million for a provision for uncollectible accounts. Cash used by working capital and other activities was primarily attributable to a \$1.8 million increase in prepaid expenses and other current assets, a \$0.4 million decrease in accounts payable, a \$4.1 million decrease in accrued expense, a \$0.2 million increase in other assets, and \$1.1 million increase in accounts receivable offset by a \$2.0 million increase in deferred revenue, and a \$0.3 million decrease in deferred rent. These changes are largely attributable to growth in the size of our business and to the cash outlay of variable employee compensation.

Cash provided by operating activities during the three months ended March 31, 2009, was \$4.5 million and consisted of net income of \$1.5 million and \$1.7 million utilized by working capital and other activities. Cash provided by operating activities included positive non-cash adjustments of \$1.7 million related to depreciation and amortization expense, a \$1.9 million non-cash stock-based compensation expense, a \$1.4 million of deferred income taxes, and \$0.1 million for a provision for uncollectible accounts. Negative non-cash adjustments related to amortization of discounts on investments of \$0.3 million and a \$0.2 million non-cash gain on interest rate derivative. Cash used by working capital and other activities was primarily attributable to a \$0.9 million increase in accounts payable, and \$0.3 million decrease in accounts receivable offset by \$3.6 million decrease in accrued expense, a \$1.2 million increase in deferred revenue, a \$0.3 million decrease in deferred rent, and a \$0.2 million decrease in prepaid expenses and other current assets. These changes are largely attributable to growth in the size of our business and in related direct operating expense.

Net cash used in investing activities was \$13.8 million for the three months ended March 31, 2010, which consisted of purchases of investments of \$27.7 million, purchases of property and equipment of \$6.8 million (including an airplane purchase of \$3.1 million), and expenditures for internal development of the athenaClinicals and athenaCommunicator applications of \$0.7 million. This is offset in part by a \$0.3 million decrease in restricted cash, a \$0.4 million in proceeds from sale of equipment and \$20.8 million in proceeds from the maturity of investments.

Net cash used in investing activities was \$11.7 million for the three months ended March 31, 2009, which consisted of purchases of investments of \$25.8 million, purchases of property and equipment of \$2.1 million, and expenditures for internal development of the athenaClinicals application of \$0.4 million. This is offset in part by a \$0.3 million decrease in restricted cash, a \$1.8 million in proceeds from sale of equipment, and \$14.5 million in proceeds from the maturity of investments.

Net cash provided by financing activities was \$2.4 million for the three months ended March 31, 2010. The majority of the cash provided in the period resulted from proceeds from the exercise of stock options and proceeds from our employee stock purchase plan during the period totaling \$3.3 million, offset by \$0.9 million in payments on debt and capital lease obligations.

Net cash used in financing activities was \$1.1 million for the three months ended March 31, 2009. The majority of the cash provided in the period resulted from the \$0.5 million in proceeds from the exercise of stock options and proceeds from our employee stock purchase plan, offset by \$1.6 million in payments on debt.

Given our profitability over the past years and our current cash and cash equivalents, short-term investments, accounts receivable, and funds available under our existing revolving credit facility with Bank of America, N.A., we believe that we will have sufficient liquidity to fund our business and meet our contractual obligations for at least the



next twelve months. We may increase our capital expenditures consistent with our anticipated growth in infrastructure and personnel, and as we expand our national presence. In addition, we may pursue acquisitions or investments in complementary businesses or technologies or experience unexpected operating losses, in which case we may need to raise additional funds sooner than expected. Accordingly, we may need to engage in private or public equity or debt financings to secure additional funds. If we raise additional funds through further issuances of equity or convertible debt securities, our existing stockholders could suffer significant dilution, and any new equity securities we issue could have rights, preferences, and privileges superior to those of holders of our common stock. Any debt financing obtained by us in the future could involve restrictive covenants relating to our capital-raising activities and other financial and operational matters, which may make it more difficult for us to obtain additional capital and to pursue business opportunities, including potential acquisitions. Beyond the twelve-month period, we intend to maintain sufficient liquidity through continued improvements in the size and profitability of our business and through prudent management of our cash resources and our credit arrangements.

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We make investments in property and equipment and in software development on an ongoing basis. Our property and equipment investments consist primarily of technology infrastructure to provide capacity for expansion of our client base, including computers and related equipment in our data centers and infrastructure in our service operations. Our software development investments consist primarily of company-managed design, development, testing, and deployment of new application functionality. Because the practice management component of athenaNet is considered mature, we expense nearly all software maintenance costs for this component of our platform as incurred. For the electronic health records ( EHR ) component of athenaNet, which is the platform for our athenaClinicals offering, we capitalize nearly all software development. In the three months ended March 31, 2010, we capitalized \$6.8 million in property and equipment and \$0.7 million in software development. In the three months ended March 31, 2009, we capitalized \$2.1 million of property and equipment and \$0.4 million of software development. We currently anticipate making aggregate capital expenditures of approximately \$17 million over the next twelve months.

**Credit Facilities*****Term and Revolving Loans***

On September 30, 2008, we entered into a credit agreement with Bank of America, N.A. This credit agreement consists of a revolving credit facility in the amount of \$15.0 million and a term loan facility in the amount of \$6.0 million. The revolving credit facility may be extended by up to an additional \$15.0 million on the satisfaction of certain conditions and includes a \$10.0 million sublimit for the issuance of standby letters of credit. The revolving credit facility matures on September 30, 2011, and the term facility matures on September 30, 2013, although either facility may be voluntarily prepaid in whole or in part at any time without premium or penalty. On September 30, 2008, we borrowed a total of \$6.0 million under the term loan facility for general working capital purposes. As of March 31, 2010, there were no amounts outstanding under the revolving credit facility.

The revolving credit loans and term loans bear interest, at our option, at either (i) the British Bankers Association London Interbank Offered Rate (known as LIBOR), or (ii) the higher of (a) the Federal Funds Rate plus 0.50% or (b) Bank of America's prime rate. For term loans, these rates are adjusted up 100 basis points for LIBOR loans and down 100 basis points for all other loans. For revolving credit loans, a margin is added to the chosen interest rate that is based on our consolidated leverage ratio, as defined in the credit agreement, which margin can range from 100 to 275 basis points for LIBOR loans and from 0 to 50 basis points for all other loans. A default rate applies on all obligations in the event of a default under the credit agreement at an annual rate equal to 2% above the applicable interest rate. We were also required to pay other customary commitment fees and upfront fees for this credit facility. The interest rate as of March 31, 2010, for the term loan and for the revolving credit facility was 4.5%.

Our obligations under the credit agreement and all related documents are collateralized by a security interest in our personal and fixture property, instruments, documents, chattel paper, deposit accounts, claims, investment property, contract rights, general intangibles, and certain intellectual property rights. As additional security, we have granted to Bank of America, N.A. a mortgage, assignment of rents, and security interest in fixtures relating to our property in Belfast, Maine, and pledged all stock of any domestic subsidiary that may be formed or acquired and 65% of our foreign subsidiaries' stock. If we acquire or form any United States subsidiary, that subsidiary shall be required to provide a joint and several guaranties of all of our obligations under the credit agreement as primary obligor.

The credit agreement contains customary default provisions, including, without limitation, defaults relating to non-payment, breach of covenants, inaccuracy of representations and warranties, default under other indebtedness (including a cross-default with our interest rate swap with Bank of America, N.A.), bankruptcy and insolvency, inability to pay debts, attachment of assets, adverse judgments, ERISA violations, invalidity of loan and collateral documents, and change of control. Upon an event of default, the lenders may terminate the commitment to make loans and the obligation to extend letters of credit, declare the unpaid principal amount of all outstanding loans and interest accrued under the credit agreement to be immediately due and payable, require us to provide cash and deposit account collateral for our letter of credit obligations, and exercise their security interests and other rights under the credit agreement. The credit agreement also contains certain financial and nonfinancial covenants, including limitations on our consolidated leverage ratio and capital expenditures. As of March 31, 2010, we were in compliance with our covenants under the credit agreement.

***Capital Leases***

As of March 31, 2010, there was a total of \$6.3 million in aggregate principal amount outstanding under a series of capital leases with one financing company. The weighted average implicit rate in the leases are 4.4% per annum, and they are payable on a monthly basis through March 2013.

**Off-Balance Sheet Arrangements**

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

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The summary of outstanding contractual obligations as of March 31, 2010, is as follows:

|                             | Total            | Payments Due by Period |                  |                  |                  |               |
|-----------------------------|------------------|------------------------|------------------|------------------|------------------|---------------|
|                             |                  | Less than<br>1<br>year | 2-3 years        | 4-5 years        | After 5<br>years | Other         |
| Long-term debt              | \$ 5,550         | \$ 300                 | \$ 600           | \$ 4,650         | \$               | \$            |
| Capital lease obligations   | 6,313            | 3,140                  | 3,173            |                  |                  |               |
| Operating lease obligations | 29,565           | 5,409                  | 10,675           | 10,710           | 2,771            |               |
| Other                       | 986              |                        |                  |                  |                  | 986           |
| <b>Total</b>                | <b>\$ 42,414</b> | <b>\$ 8,849</b>        | <b>\$ 14,448</b> | <b>\$ 15,360</b> | <b>\$ 2,771</b>  | <b>\$ 986</b> |

These amounts exclude interest payments of \$0.3 million that are due in the next three years on capital lease obligations.

These amounts exclude interest payments of \$1.3 million that are due in the next five years on our long-term debt.

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

Other amount consists of uncertain tax benefits. We have not utilized these credits, nor do we have an expectation of when these credits would be challenged. As of March 31, 2010, we cannot reasonably estimate when any future cash outlays would occur related to these uncertain tax positions.

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

*Foreign Currency Exchange Risk.* Our results of operations and cash flows are subject to fluctuations due to changes in the Indian rupee. None of our consolidated revenues are generated outside the United States. None of our vendor relationships, including our contract with our offshore service providers International Business Machines Corporation and Vision Business Process Solutions, Inc., a subsidiary of Dell, Inc. (formerly Perot Systems Corporation), for work performed in India and the Philippines, is denominated in any currency other than the U.S. dollar. For the three months ended March 31, 2010, less than 1% of our expenses occurred in our direct subsidiary in Chennai, India, and were incurred in Indian rupees. We therefore believe that the risk of a significant impact on our operating income from foreign currency fluctuations is not substantial.

*Interest Rate Sensitivity.* We had unrestricted cash, cash equivalents and short-term investments totaling \$79.1 million at March 31, 2010. These amounts are held for working capital purposes and were invested primarily in deposits, money market funds, and short-term, interest-bearing, investment-grade securities. Due to the short-term nature of these investments, we believe that we do not have any material exposure to changes in the fair value of our investment portfolio as a result of changes in interest rates. The value of these securities, however, will be subject to interest rate risk and could fall in value if interest rates rise.

*Interest Rate Risk.* As of March 31, 2010, we had long-term debt and capital lease obligations totaling \$11.9 million, which have both variable and fixed interest rate components. We have entered into an interest rate swap intended to mitigate variability in interest rate movements on our term loan. The swap has an amortizing notional amount over the swap agreement. For floating rate debt, interest rate changes generally do not affect the fair market value, but do impact future earnings and cash flows, assuming other factors are held constant.

The table below summarizes the principal terms of our interest rate swap transaction, including the notional amount of the swap, the interest rate payment we receive from and pay to our swap counterparty, the term of the transaction, and its fair market value at March 31, 2010.

**Remaining  
Notional**

**Maturity  
(Fiscal**

| Description        | Underlying            | Amount  | Receive       | Pay   | Fiscal Year Entered Into | Year) | Fair Value at March 31, 2010 |
|--------------------|-----------------------|---------|---------------|-------|--------------------------|-------|------------------------------|
| Interest rate swap |                       |         |               | 4.55% |                          |       |                              |
| variable to fixed  | Interest on Term Loan | \$5,550 | LIBOR plus 1% | fixed | 2008                     | 2028  | \$ (351)                     |

At March 31, 2010, there were no amounts outstanding under the revolving credit facility; however, we can draw up to \$15.0 million under this line of credit at any time. At March 31, 2010, there was \$5.6 million outstanding on the term loan. If we had

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drawn the total available amount, and if the prime rate thereon had fluctuated by 10%, the interest expense would have fluctuated by approximately \$0.1 million.

**Item 4. Controls and Procedures.**

**Disclosure Controls and Procedures**

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed by us in reports we file or submit under the Securities and Exchange Act of 1934 is processed, summarized, and reported within the time periods specified in the SEC's rules and forms. As of March 31, 2010 (the Evaluation Date), our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities and Exchange Act of 1934). Our management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives, and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Our Chief Executive Officer and Chief Financial Officer have concluded based upon the evaluation described above that, as of the Evaluation Date, our disclosure controls and procedures were effective at the reasonable assurance level.

**Changes in Internal Control Over Financial Reporting**

As previously described in Item 9A Controls and Procedures in our Annual Report on Form 10-K filed for the year ended December 31, 2009, we identified a material weakness in internal controls over financial reporting relating to the application of applicable accounting literature related to revenue recognition for implementation fees. Specifically, the control deficiency related to our interpretation of the Revenue Recognition Topic of the FASB Accounting Standards Codification in determining the proper period over which to amortize implementation fees. We believe that, in the context of the rapid growth of our business, we did not have sufficient staffing and technical expertise in the area of revenue recognition accounting to provide adequate review and control with respect to accounting for implementation revenue accounting. This material weakness contributed to material post-closing adjustments and restatement of prior period financial statements, which were reflected in the financial statements for the three years ended December 31, 2009.

During the period covered by this report, we completed remediation efforts to address the material weakness identified above. Specifically we implemented the following changes in internal controls during the first quarter of 2010:

in January 2010, we hired a new Chief Financial Officer, who has extensive experience leading the accounting and finance functions at publicly traded companies and adds accounting expertise to our staff;

in February 2010, we engaged external advisors knowledgeable in revenue recognition to assist us in the interpretation of key technical revenue recognition standards and associated interpretations and the determination of how they apply to our software-enabled service business model; and

we revised our internal training program to ensure that our finance personnel have the competence and the on-going accounting and financial reporting training necessary for their assigned duties, including specific technical training courses related to revenue recognition topics. To that end, we increased our training budget significantly over the amount spent in 2009 for technical training and development.

Other than as described above, there have been no changes in our internal control over financial reporting for the quarter ended March 31, 2010, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**Table of Contents****PART II. OTHER INFORMATION****Item 1. Legal Proceedings.**

On March 2, 2010, a complaint was filed by *Prompt Medical Systems, L.P.* naming the Company and several other defendants in a patent infringement case (*Prompt Medical Systems, L.P. v. AllscriptsMisys Healthcare Solutions, Inc. et al*, Civil Action No. 6:2010cv00071, United States District Court for the Eastern District of Texas). The complaint alleges that we have infringed on a patent with a listed issue date in 1996 entitled *Method for Computing Current Procedural Terminology Codes from Physician Generated Documentation* and seeks an injunction enjoining infringement, damages, and pre- and post-judgment costs and interest. At this time, we have been served with process in connection with this case, and a response to the complaint is currently due by May 26, 2010. We believe that we have meritorious defenses to the complaint, and we will contest the claims vigorously.

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

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

**Item 1A. Risk Factors.**

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

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

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

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

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

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

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

the length of our contracting and implementation cycles;

changes in Client Days in Accounts Receivable;

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

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

the financial condition of our current and potential clients;

changes in client budgets and procurement policies;

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

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

technical difficulties or interruptions in our services;

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

changes in the regulatory environment related to healthcare;

regulatory compliance costs;

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

unforeseen legal expenses, including litigation and settlement costs.

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

A significant portion of our operating expense is relatively fixed in nature, and planned expenditures are based in part on expectations regarding future revenue and profitability. Accordingly, unexpected revenue shortfalls, lower



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than expected revenue increases as a result of planned expenditures, and longer than expected impact on profitability and margins as a result of planned revenue expenditures may decrease our gross margins and profitability and could cause significant changes in our operating results from quarter to quarter. In addition, our future quarterly operating results may fluctuate and may not meet the expectations of securities analysts or investors. If this occurs, the trading price of our common stock could fall substantially either suddenly or over time.

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

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

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

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

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

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

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

Not applicable.

**Item 3. Default Upon Senior Securities.**

Not applicable.

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

**Item 5. Other Information.**

Not applicable.

**Item 6. Exhibits.**

(a) Exhibits.

**Exhibit**

**No.**

**Exhibit Index**

|        |  |
|--------|--|
| 10.1** | 2007 Employee Stock Purchase Plan, as amended  |
| 10.2** | Employment Agreement by and between the Registrant and Timothy M. Adams, dated January 11, 2010.   |
| 31.1** | Rule 13a-14(a) or 15d-14 Certification of Chief Executive Officer  |
| 31.2** | Rule 13a-14(a) or 15d-14 Certification of Chief Financial Officer  |
| 32.1** | Certifications of Chief Executive Officer and Chief Financial Officer pursuant to Exchange Act rules 13a-14(b) or 15d-14(b) and 18 U.S.C. Section 1350 |

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

\*\* Filed herewith

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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

ATHENAHEALTH, INC.

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

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

Date: May 3, 2010