

ATHENAHEALTH INC
Form 10-Q
July 19, 2013
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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 June 30, 2013

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

(State or other jurisdiction of incorporation or organization)

04-3387530

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

311 Arsenal Street,
Watertown, Massachusetts

(Address of principal executive offices)

617-402-1000

(Registrant’s telephone number, including area code)

02472

(Zip Code)

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

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

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

Large accelerated filer

Accelerated filer

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

Smaller reporting company

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

At July 17, 2013, the registrant had 36,848,900 shares of common stock, par value \$0.01 per share, outstanding.

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PART I - FINANCIAL INFORMATION

Item 1. Condensed Consolidated Financial Statements (unaudited).
athenahealth, Inc.

CONDENSED CONSOLIDATED BALANCE SHEETS

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

	June 30, 2013	December 31, 2012
Assets		
Current assets:		
Cash and cash equivalents	\$33,558	\$154,988
Short-term investments	—	38,092
Accounts receivable - net	93,319	61,916
Current portion of restricted cash	—	1,357
Deferred tax assets - net	4,511	6,907
Prepaid expenses and other current assets	19,798	10,924
Total current assets	151,186	274,184
Property and equipment - net	204,728	54,035
Capitalized software costs - net	22,428	16,050
Purchased intangible assets - net	180,382	21,561
Goodwill	196,183	48,090
Deferred tax assets - net	—	11,759
Investments and other assets	4,461	2,773
Total assets	\$759,368	\$428,452
Liabilities and Stockholders' Equity		
Current liabilities:		
Line of credit	\$50,000	\$—
Current portion of long-term debt	15,000	—
Accounts payable	6,679	1,733
Accrued compensation	37,108	36,393
Accrued expenses	23,373	19,683
Current portion of deferred revenue	35,064	8,209
Current portion of deferred rent	21	799
Total current liabilities	167,245	66,817
Deferred rent, net of current portion	—	2,854
Long-term debt, net of current portion	181,250	—
Deferred revenue, net of current portion	51,080	45,515
Long-term deferred tax liability - net	20,165	—
Other long-term liabilities	4,912	1,618
Total liabilities	424,652	116,804
Commitments and contingencies (note 7)		
Stockholders' equity:		
Preferred stock, \$0.01 par value: 5,000 shares authorized; no shares issued and outstanding at June 30, 2013, and December 31, 2012, respectively	—	—
Common stock, \$0.01 par value: 125,000 shares authorized; 38,089 shares issued and 36,811 shares outstanding at June 30, 2013; 37,572 shares issued and 36,294 shares outstanding at December 31, 2012	381	376
Additional paid-in capital	338,457	303,547
Treasury stock, at cost, 1,278 shares	(1,200) (1,200
Accumulated other comprehensive loss	(207) (81

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Retained (accumulated deficit) earnings	(2,715) 9,006
Total stockholders' equity	334,716	311,648
Total liabilities and stockholders' equity	\$759,368	\$428,452

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

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athenahealth, Inc.

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

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

	Three Months Ended June 30,		Six Months Ended June 30,		
	2013	2012	2013	2012	
Revenue:					
Business services	\$137,919	\$100,110	\$259,382	\$193,659	
Implementation and other	8,382	3,405	12,515	6,422	
Total revenue	146,301	103,515	271,897	200,081	
Expense:					
Direct operating	59,390	41,014	112,575	79,812	
Selling and marketing	41,035	27,389	73,957	51,117	
Research and development	14,269	8,615	26,213	15,783	
General and administrative	24,670	13,961	55,747	30,160	
Depreciation and amortization	11,107	5,795	19,448	11,281	
Total expense	150,471	96,774	287,940	188,153	
Operating (loss) income	(4,170	) 6,741	(16,043	) 11,928
Other (expense) income:					
Interest expense	(1,001) (88) (1,165) (176)
Other income	63	100	117	322	
Total other (expense) income	(938	) 12	(1,048	) 146
(Loss) income before income tax (provision) benefit	(5,108	) 6,753	(17,091	) 12,074
Income tax (provision) benefit	(7,313) (2,599) 5,370	(5,492)
Net (loss) income	\$(12,421	) \$4,154	\$(11,721	) \$6,582
Net (loss) income per share – Basic	\$(0.34	) \$0.12	\$(0.32	) \$0.18
Net (loss) income per share – Diluted	\$(0.34	) \$0.11	\$(0.32	) \$0.18
Weighted average shares used in computing net (loss) income per share:					
Basic	36,760	35,685	36,598	35,713	
Diluted	36,760	36,906	36,598	36,951	

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

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athenahealth, Inc.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited, amounts in thousands)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Net (loss) income	\$(12,421)	\$4,154	\$(11,721)	\$6,582
Other comprehensive (loss) income:				
Unrealized (loss) gain on securities, net of tax of \$0 and \$10 for the three and six months ended June 30, 2013 and 2012, respectively	(20)	(34)	(20)	38
Foreign currency translation adjustment	180	(12)	144	(21)
Total other comprehensive income (loss)	160	(46)	124	17
Comprehensive (loss) income	\$(12,261)	\$4,108	\$(11,597)	\$6,599

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, amounts in thousands)

	Six Months Ended June 30,	
	2013	2012
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net (loss) income	\$(11,721	) \$6,582
Adjustments to reconcile net (loss) income to net cash provided by operating activities:		
Depreciation and amortization	26,226	12,861
Amortization of premium on investments	84	681
Provision for uncollectible accounts	453	287
Excess tax benefit from stock-based awards	—	(5,680
Deferred income tax	(5,492	) (426
Change in fair value of contingent considerations	—	(1,110
Stock-based compensation expense	24,042	12,984
Other reconciling adjustments	90	(120
Changes in operating assets and liabilities:		
Accounts receivable	(8,712	) (2,134
Prepaid expenses and other current assets	(5,069	) 605
Other long-term assets	493	117
Accounts payable	2,864	1,222
Accrued expenses	(796	) 1,742
Accrued compensation	(1,307	) (683
Deferred revenue	2,232	1,108
Deferred rent	(3,632	) (438
Net cash provided by operating activities	19,755	27,598
CASH FLOWS FROM INVESTING ACTIVITIES:		
Capitalized software development costs	(12,993	) (5,915
Purchases of property and equipment	(16,601	) (15,657
Proceeds from sales and maturities of investments	56,245	46,374
Purchases of short-term and long-term investments	—	(30,883
Payments on acquisitions, net of cash acquired	(410,161) —
Decrease in restricted cash	1,357	807
Other investing activities	—	172
Net cash used in investing activities	(382,153	) (5,102
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from issuance of common stock under stock plans and warrants	12,248	10,905
Taxes paid related to net share settlement of restricted stock units	(9,924	) (3,686
Excess tax benefit from stock-based awards	—	5,680
Payment of contingent consideration accrued at acquisition date	—	(807
Debt issuance costs	(1,592) —
Net settlement of acquired company's board of directors equity shares	(5,806) —
Proceeds from long-term debt	200,000	—
Net proceeds from line of credit	155,000	—
Payments from line of credit	(105,000) —
Payments from long-term debt	(3,750) —
Net cash provided by financing activities	241,176	12,092
Effects of exchange rate changes on cash and cash equivalents	(208) (39
Net (decrease) increase in cash and cash equivalents	(121,430) 34,549

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Cash and cash equivalents at beginning of period	154,988	57,781
Cash and cash equivalents at end of period	\$33,558	\$92,330
Non-cash transactions		
Property, equipment and purchased software recorded in accounts payable and accrued expenses	\$268	\$450
Tax benefit recorded in prepaid expenses and other current assets	\$—	\$5,651
Fair value of equity awards assumed	\$13,028	\$—
Additional disclosures		
Cash received for interest	\$451	\$51
Cash paid for interest	\$927	\$—
Cash paid for taxes	\$994	\$3,824

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

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athenahealth, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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

1. BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements have been prepared by athenahealth, Inc. (the “Company” or “we”) in accordance with accounting principles generally accepted in the United States (“GAAP”) for interim financial reporting and as required by Regulation S-X, Rule 10-01. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of the Company’s management, the accompanying unaudited condensed consolidated financial statements contain all adjustments (consisting of items of a normal and recurring nature) necessary to present fairly the financial position as of June 30, 2013, and the results of operations and cash flows for the six month period ended June 30, 2013, and 2012. The results of operations for the six month period ended June 30, 2013, 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 and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. 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, 2012, included in our Annual Report on Form 10-K, which was filed with the Securities and Exchange Commission (“SEC”) on February 11, 2013.

Segment Reporting – The Company discloses information about its operating segments based on the way that management organizes the segments within the Company for making operating decisions and assessing financial performance. Operating segments are identified as components of an enterprise about which separate discrete financial information is evaluated by the chief decision-maker (“CODM”), or decision-making group, in making decisions regarding resource allocation and assessing performance. The Company is in the process of analyzing the information that will be prepared and presented to the CODM due to the acquisitions of Epocrates, Inc. and the Arsenal on the Charles during the six months ended June 30, 2013 (see footnote 2). We anticipate that we will have at least two operating segments – athenahealth and Epocrates. Historically, the Company has operated in one segment.

Interim Tax Estimate – Due to the fact that we are projecting a nominal pre-tax income for the year and have significant permanent differences, we cannot reasonably predict our estimated effective tax rate for the year; therefore, we have used a discrete tax approach for the period ended June 30, 2013, in calculating the year-to-date provision.

2. ACQUISITIONS

Watertown, MA Corporate Headquarters – Arsenal on the Charles

On May 10, 2013, the Company, through its wholly-owned subsidiary Athena Arsenal, LLC (“Athena Arsenal”), completed the acquisition of the real estate commonly known as the Arsenal on the Charles, located in Watertown, Massachusetts. The Arsenal on the Charles is an expansive 29-acre, multi-building, commercial property where the Company was leasing space for its headquarters and related operating activities prior to the transaction. The purpose of this acquisition is to allow for future expansion of the corporate headquarters to accommodate anticipated headcount growth. The purchase price was \$168.5 million, subject to working capital adjustments. The fair value of the consideration paid was \$167.3 million, all of which was paid in cash.

The following table summarizes the estimated fair values of assets acquired and liabilities assumed as of the date of acquisition:

Prepaid expenses and other current assets	\$685
Property, equipment and buildings	144,071
Purchased intangible assets	25,545

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Accrued expenses	(271)
Deferred revenue	(789)
Other long-term liabilities	(1,916)
Total identifiable net assets	\$167,325	

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The fair values assigned to tangible and identifiable intangible assets acquired and liabilities assumed are based on management's estimates and assumptions and are based on the information that was available as of the date of the acquisition. The Company believes that the information provides a reasonable basis for estimating the fair values of assets acquired and liabilities assumed, but certain items such as the value of the purchased tangible and intangible assets and certain working capital adjustments to the purchase price may be subject to change as additional information is received about facts and circumstances that existed at the date of acquisition. Thus, the provisional measurements of fair value set forth above are subject to change. The Company expects to finalize the valuation as soon as practicable, but not later than one year from the acquisition date.

The following table sets forth the preliminary components of the identifiable intangible assets acquired by asset class:

	Fair value
Above market leases	\$3,298
Leases in place	22,247
Total intangible assets subject to amortization	\$25,545

The value of any in-place lease is estimated to be equal to the property owners' avoidance of costs necessary to release the property for a lease term equal to the remaining primary in-place lease term and the value of investment grade tenancy. The cost avoidance to the property owners' of vacancy/leasing costs necessary to lease the property for a lease term equal to the remaining in-place lease term is derived first by determining the in-place lease term on the subject lease. Then, based on our review of the market, the cost to be borne by a property owner to replicate a market lease to the remaining in-place term was estimated. These costs consist of: (i) rent lost during downtime (i.e., assumed periods of vacancy), (ii) estimated expenses that would be incurred by the property owner during periods of vacancy, (iii) rent concessions (i.e., free rent), (iv) leasing commissions, and (v) tenant improvement allowances. The Company determines these values using our estimates along with third-party appraisals. The Company amortizes the capitalized value of in-place lease intangible assets to expense over the remaining initial term of each lease. The Company amortizes the capitalized value of above market leases to expense over the initial and expected renewal terms of the leases. No amortization period for intangible assets will exceed the remaining depreciable life of the building.

The amounts of revenue and net loss from the Arsenal on the Charles included in the Company's condensed consolidated statements of income from the acquisition date of May 10, 2013, to the period ended June 30, 2013, are \$2.2 million and \$1.3 million, respectively.

The Company incurred transaction costs in connection with the acquisition of \$1.4 million and \$2.4 million during the three and six months ended June 30, 2013, respectively, and \$3.1 million in total. These costs are included in general and administrative expenses.

Epocrates, Inc.

On March 12, 2013, the Company acquired Epocrates, Inc. ("Epocrates"), a leading provider of essential clinical content, practice tools, and health industry engagement via mobile devices at the point of care. The Company acquired Epocrates for the assembled workforce, expected synergies, and accelerated awareness of athenahealth's services across the physician market and to deliver high-value information to the clinical community. The acquisition date fair value of the consideration transferred for Epocrates, less cash and short-term investments acquired was approximately \$237.6 million, which consisted of the following:

Fair value of consideration transferred

Cash payments	\$294,632	
Fair value of vested stock options and restricted stock units assumed	13,028	
Fair value of total consideration	307,660	
Less cash acquired	(51,796)
Less short-term investments acquired	(18,250)
Total	\$237,614	

The value of the share consideration for Epocrates' common stock was based on the average closing sales prices per share of the Company's common stock for the ten trading days ending on the second trading day prior to the closing of

the acquisition. The fair value of the stock options and restricted stock units assumed by the Company was determined using the

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Black-Scholes option pricing model. The share conversion ratio of 0.1239 was applied to convert Epocrates options and restricted stock units to the Company's options and restricted stock units.

The Company assumed options and restricted stock units with a fair value of \$22.6 million. Of the total consideration, \$13.0 million was allocated to the purchase consideration and \$9.6 million was allocated to future services and will be expensed over the remaining service periods on a straight-line basis over the remaining service period. In the six months ended June 30, 2013, stock-based compensation expense recognized for stock options and restricted stock units assumed was \$6.2 million.

The following table summarizes the estimated fair values of assets acquired and liabilities assumed as of the date of acquisition:

Accounts receivable	\$23,144	
Other current and long-term assets	3,833	
Property, equipment and capitalized software costs	4,168	
Purchased intangible assets	139,900	
Current liabilities	(11,054))
Deferred tax liabilities, net	(39,811))
Deferred revenue	(29,400))
Other long-term liabilities	(1,259))
Total identifiable net assets	\$89,521	
Goodwill	148,093	
	\$237,614	

The excess of purchase consideration over the fair value of net tangible and identifiable intangible assets acquired was recorded as goodwill. The fair values assigned to tangible and identifiable intangible assets acquired and liabilities assumed are based on management's estimates and assumptions and are based on the information that was available as of the date of the acquisition. The Company believes that the information provides a reasonable basis for estimating the fair values of assets acquired and liabilities assumed, but certain items such as accounts receivable, purchased intangible assets, current and non-current income taxes payable, deferred taxes, and uncertain tax benefits may be subject to change as additional information is received about facts and circumstances that existed at the date of acquisition and certain tax returns are finalized. Thus, the provisional measurements of fair value set forth above are subject to change. The Company expects to finalize the valuation as soon as practicable, but not later than one year from the acquisition date.

The following table sets forth the preliminary components of the identifiable intangible assets acquired by asset class and their preliminary estimated useful lives as of the date of acquisition:

	Fair Value	Useful Life
Doctor network	\$104,500	14 years
Drug information content	10,000	5 years
Trade name	11,500	10 years
Customer backlog	2,900	1.5 years
Epocrates non-compete agreement	4,500	1.5 years
Developed technology	6,500	3 years
Total intangible assets subject to amortization	\$139,900	

We anticipate that we will allocate the acquired doctor network among our operating segments once determined. The Epocrates segment will represent the fair values of the underlying relationships and agreements with Epocrates customers. The doctor network related to the athenahealth segment will represent the fair values of the savings associated with future marketing spend for the athenahealth segment services to the acquired doctor network. Drug information content represents the fair value of the cost to replace the drug information and interaction content used by the doctor's network. The trade name represents the fair value of the brand and name recognition associated with the marketing of Epocrates' service offerings. Developed technology represents the estimated fair value of Epocrates' mobile device platform. All of the purchased intangible assets related to the Epocrates transaction have finite lives. For those purchased intangible assets where an income approach was used, we considered the projected undiscounted

cash flows as the best indication of the pattern of economic benefit expected from the asset.

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The goodwill balance is primarily attributed to the assembled workforce and expanded market opportunities when integrating Epocrates' mobile device platform with the athenahealth service offerings. We anticipate goodwill will be allocated among our operating segments once determined. The goodwill balance is not deductible for U.S. income tax purposes.

The amounts of revenue and net loss of Epocrates included in the Company's condensed consolidated statements of income from the acquisition date of March 12, 2013, to the period ended June 30, 2013, are \$20.1 million and \$12.7 million, respectively. The net loss includes \$6.2 million in stock-based compensation expense primarily related to the acceleration of certain individuals' stock awards upon termination.

The Company incurred transaction costs in connection with the acquisition of \$0.2 million and \$2.7 million during the three and six months ended June 30, 2013, respectively, and \$3.2 million in total. These costs are included in general and administrative expenses.

As part of the integration of Epocrates, the Company communicated to certain employees severance and retention bonuses which total \$4.2 million to be paid through the end of 2013. The following table summarizes these amounts on the condensed consolidated statements of income, for the six months ended June 30, 2013:

Summary of roll forward of integration costs

Beginning balance, January 1, 2013	\$—	
Addition to provision	2,209	
Cash outlay	(195)
Ending balance, March 31, 2013	\$2,014	
Addition to provision	979	
Change in estimate	(129)
Cash outlay	(1,122)
Ending balance, June 30, 2013	\$1,742	

Pro Forma Presentation

The following pro forma financial information summarizes the combined results of operations for the Company as though the acquisitions of Epocrates and the Arsenal on the Charles occurred on January 1, 2012. The unaudited pro forma financial information is as follows:

	Three months ended June 30,		Six months ended June 30,	
	2013	2012	2013	2012
Revenue	\$ 148,035	\$ 131,868	\$ 291,669	\$ 257,840
Net loss	\$(13,057)	\$(1,202)	\$(16,123)	\$(10,083)
Net loss per share – Basic	\$(0.36)	\$(0.03)	\$(0.44)	\$(0.28)
Net loss per share – Diluted	\$(0.36)	\$(0.03)	\$(0.44)	\$(0.27)

The pro forma financial information for all periods presented has been calculated after adjusting the results of Epocrates and the Arsenal on the Charles to reflect the business combination accounting effects resulting from these acquisitions including the amortization expenses from acquired intangible assets, the depreciation expenses from acquired tangible assets, the stock-based compensation expense for unvested stock options and restricted stock units assumed and the related tax effects as though the acquisition occurred as of January 1, 2012. The pro forma financial information is for informational purposes only and is not indicative of the results of operations that would have been achieved if the acquisition had taken place at the beginning of the Company's 2012 fiscal year.

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athenahealth, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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

3. NET (LOSS) INCOME PER SHARE

Basic net (loss) income per share is computed by dividing net (loss) income by the weighted average number of common shares outstanding during the period. Diluted net (loss) income per share is computed by dividing net (loss) income by the weighted average number of common shares outstanding and potentially dilutive securities outstanding during the period under the treasury stock method. Potentially dilutive securities include stock options, restricted stock units, and shares to be purchased under the employee stock purchase plan. Under the treasury stock method, dilutive securities are assumed to be exercised at the beginning of the period 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 anti-dilutive to earnings per share.

The following table reconciles the weighted average shares outstanding for basic and diluted net (loss) income per share for the periods indicated:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Net (loss) income	\$(12,421)	\$4,154	\$(11,721)	\$6,582
Weighted average shares used in computing basic net (loss) income per share	36,760	35,685	36,598	35,713
Net (loss) income per share – Basic	\$(0.34)	\$0.12	\$(0.32)	\$0.18
Net (loss) income	\$(12,421)	\$4,154	\$(11,721)	\$6,582
Weighted average shares used in computing basic net (loss) income per share	36,760	35,685	36,598	35,713
Effect of dilutive securities	—	1,221	—	1,238
Weighted average shares used in computing diluted net (loss) income per share	36,760	36,906	36,598	36,951
Net (loss) income per share – Diluted	\$(0.34)	\$0.11	\$(0.32)	\$0.18

The computation of diluted net income per share does not include 0.4 million and 0.4 million of stock options and restricted stock units for the three and six months ended June 30, 2012, respectively, because their inclusion would have an anti-dilutive effect on net income per share.

4. FAIR VALUE OF FINANCIAL INSTRUMENTS

As of June 30, 2013, and December 31, 2012, the carrying amounts of cash and cash equivalents, restricted cash, receivables, accounts payable and accrued expenses approximated their estimated fair values because of the short-term nature of these financial instruments. Included in cash and cash equivalents as of June 30, 2013, and December 31, 2012, are money market fund investments of \$0.1 million and \$59.4 million, respectively, which are reported at fair value. As of June 30, 2013, the Company had \$246.3 million outstanding on its credit facility (refer to Note 6) which approximates fair value based on the timing of when we entered into the credit facility. As of December 31, 2012, the Company had no outstanding debt.

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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 June 30, 2013, and December 31, 2012, 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 active markets for similar assets or liabilities. The fair values determined by Level 3 inputs are unobservable values which are supported by little or no market activity.

Fair Value Measurements At June 30, 2013,

Using

	Level 1	Level 2	Level 3	Total
Cash and cash equivalents:				
Money market	\$128	\$—	\$—	\$128
Total assets	\$128	\$—	\$—	\$128
Accrued contingent consideration	\$—	\$—	\$(448)	\$(448)
Total liabilities	\$—	\$—	\$(448)	\$(448)

Fair Value Measurements as of December 31,
2012, Using

	Level 1	Level 2	Level 3	Total
Cash and cash equivalents:				
Money market	\$89,480	\$—	\$—	\$89,480
Available-for-sale investments:				
Commercial paper	—	11,748	—	11,748
Corporate bonds	—	20,334	—	20,334
Certificate of deposit	—	6,010	—	6,010
Total assets	\$89,480	\$38,092	\$—	\$127,572
Accrued contingent consideration	\$—	\$—	\$(448)	\$(448)
Total liabilities	\$—	\$—	\$(448)	\$(448)

Money market funds, certificates of deposit, 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. 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 any periods presented.

Contingent consideration is recorded at fair value as an element of consideration paid with subsequent adjustments recognized in the consolidated statement of income. At the acquisition date and reporting date, the fair value of the accrued contingent consideration was determined using a probability-weighted income approach based on upside, downside and base case scenarios. This approach is based on significant inputs that are not observable in the market, which are referred to as Level 3 inputs. The outstanding potential contingent consideration related to the Company's acquisition of Proxsys in 2011 ranges from zero to \$5.0 million and is payable in quarterly installments based upon the cross-selling of the Company's athenaCollector services into Proxsys' new and acquired customer and physician sender base, from the acquisition date to the second year anniversary of the acquisition in the third quarter of 2013. As of June 30, 2013 and December 31, 2012, the Company has a probability adjusted level of 60% for the base case and 20% for the upside and downside scenarios. The Company estimates the fair value of the contingent consideration at June 30, 2013 to be \$0.4 million, primarily related to how much has been earned and the amount of time left to earn the additional consideration.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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

The reconciliations for the fair values of financial instruments determined by Level 3 for the periods presented, are as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Balance beginning of period	\$ 448	\$ 8,143	\$ 448	\$ 8,176
Payments	—	(703)	—	(807)
Change in fair value (included in general and administrative expenses)	—	(1,181)	—	(1,110)
Balance end of period	\$ 448	\$ 6,259	\$ 448	\$ 6,259

5. PROPERTY AND EQUIPMENT

The fair values of the property and equipment acquired as part of the purchase of the Arsenal on the Charles are allocated to buildings, land, and land improvements in the amounts of \$121.3 million, \$21.0 million, and \$1.8 million, respectively.

Property and equipment consist of the following as of:

	June 30, 2013	December 31, 2012
Equipment	\$ 70,891	\$ 56,078
Furniture and fixtures	7,163	5,297
Leasehold improvements	1,684	15,518
Airplane	3,156	3,156
Building	136,029	14,644
Building improvements	18,679	3,500
Land	23,059	2,035
Land improvements	2,714	915
Total property and equipment, at cost	263,375	101,143
Accumulated depreciation and amortization	(61,591)	(49,902)
Construction in progress	2,944	2,794
Property and equipment, net	\$ 204,728	\$ 54,035

Depreciation expense on property and equipment was \$7.4 million and \$3.9 million for the three months ended June 30, 2013 and 2012, respectively. Depreciation expense on property and equipment was \$11.7 million and \$7.8 million for the six months ended June 30, 2013 and 2012, respectively.

6. DEBT

2011 Line of Credit – On October 20, 2011, the Company entered into a \$100.0 million revolving credit agreement (“Revolving Credit Agreement”) with a term of five years. The Revolving Credit Agreement replaced the \$15.0 million Credit Agreement that expired September 30, 2011. The Revolving Credit Agreement contains certain covenants, including consolidated leverage and minimum fixed charge coverage ratios. The interest rates applicable to revolving loans under the Revolving Credit Agreement are at either (i) the British Bankers Association London Interbank Offered Rate (“LIBOR”) plus an interest margin based on our consolidated leverage ratio, or (ii) the base rate (which is the highest of (a) the bank’s prime rate, (b) the Federal Funds rate plus 0.50%, and (c) one month LIBOR plus 1.00%) plus an interest margin based on the Company’s consolidated leverage ratio. The Company was required to pay financing fees of \$0.7 million for the Revolving Credit Agreement, which are being amortized in interest expense in the Consolidated Statements of Income over the five-year term. As of December 31, 2012, the Company had no outstanding debt obligations.

2013 Commitment Letter – On January 7, 2013, the Company entered into a commitment letter, pursuant to which Bank of America, N.A. committed to increase its commitment to provide revolving loans under the Revolving Credit Agreement by an amount up to \$55 million as a source of funding for the Epocrates transaction (refer to Note 2). The Company was required to

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

pay financing fees of \$0.3 million for this commitment which are being amortized in interest expense in the Consolidated Statements of Income over the remaining five-year term of the Revolving Credit Agreement.

On March 11, 2013, the Company borrowed \$155.0 million under the Revolving Credit Agreement as a source of funding for the Epocrates transaction. The Company repaid \$50.0 million of the \$155.0 million as of March 31, 2013. All amounts outstanding under the Revolving Credit Agreement were repaid on May 10, 2013, as discussed below.

2013 Credit Agreement – On May 10, 2013, the Company entered into a \$325 million senior credit facility consisting of a \$200 million unsecured term loan facility and a \$125 million unsecured revolving credit facility (“Senior Credit Facility”). The Company may increase the Senior Credit Facility up to an additional \$100 million, subject to certain conditions including obtaining lender commitments. The terms and conditions of the Senior Credit Facility are customary to facilities of this nature. The Senior Credit Facility expires on May 10, 2018, although the Company may prepay the Senior Credit Facility in whole or in part at any time without premium or penalty, and the unutilized portion of the commitments may be irrevocably reduced or terminated by the Company in whole or in part without penalty or premium. The Senior Credit Facility contains customary default provisions and certain financial and nonfinancial covenants including limitations on our consolidated leverage ratio and capital expenditures.

On May 10, 2013, the Company borrowed \$200 million under the unsecured term loan facility and \$50 million under the unsecured revolving credit facility of the Senior Credit Facility to refinance existing indebtedness described above, to finance the Arsenal on the Charles acquisition as described in Note 2, and for working capital and other general corporate purposes. The unsecured term loan facility is payable quarterly starting June 30, 2013, in the amount of \$3.75 million each quarter. As of June 30, 2013, the Company had \$196.25 million outstanding on the unsecured term loan facility and \$50.0 million outstanding on the unsecured revolving credit facility. As of June 30, 2013, the Company had \$75 million available on the unsecured revolving credit facility.

Any loan under the Senior Credit Facility will bear interest at the same rates as in the Revolving Credit Agreement.

The interest rate for the Senior Credit Facility as of June 30, 2013 was 1.95%.

The Company was required to pay financing fees of \$1.3 million for the Senior Credit Facility, which are being amortized in interest expense in the Consolidated Statements of Income over the five-year term.

Future principle payments of the unsecured term loan at June 30, 2013, are as follows:

	Amount
Remaining 2013	\$7,500
2014	15,000
2015	15,000
2016	15,000
2017	15,000
Thereafter	128,750
Total	196,250
Less current portion	15,000
Long-term portion	\$181,250

7. COMMITMENTS AND CONTINGENCIES

On January 11, 2013, a complaint captioned *Bushansky v. Epocrates, Inc., et al.*, Case No. 519078, was filed in San Mateo County Superior Court on behalf of a putative class of Epocrates’ shareholders against Epocrates and each member of the Epocrates board. This complaint challenged the proposed merger between Epocrates and one of the Company’s wholly owned subsidiaries. On January 25, 2013, a similar complaint was filed in San Mateo County Superior Court captioned *DeJoyce v. Epocrates, et al.*, Case No. 519461. This second complaint made similar allegations against Epocrates and each member of the Epocrates board and included a claim against the Company for aiding and abetting a breach of fiduciary duty. On January 31, 2013, the *Bushansky* complaint was amended to include additional allegations. Plaintiffs allege, among other things, that the Epocrates directors breached their fiduciary duties by allegedly agreeing to sell Epocrates at an unfair and inadequate price, failing to take steps to

maximize the sale price of Epocrates, and making material omissions to the preliminary proxy statement dated January 25, 2013. The complaints sought to enjoin the merger, other equitable relief, and money damages. On March 5, 2013, Epocrates and the plaintiffs signed a memorandum of understanding in which the parties agreed to enter into a stipulation of settlement whereby the plaintiffs and all class members would release all claims related to the merger in exchange for Epocrates filing a supplement to its definitive

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

proxy statement regarding the merger with the Securities and Exchange Commission, which would include additional disclosures regarding the merger agreement, and an agreement to negotiate in good faith regarding the amount of attorneys' fees and expenses for which plaintiffs may seek approval from the Court. The Company expects its maximum exposure for this matter will be the Company's insurance deductible of \$0.5 million.

In addition, the Company is engaged from time to time in certain legal disputes arising in the ordinary course of business, including employment discrimination claims and challenges to the Company's intellectual property. The Company believes that it has adequate legal defenses and that the likelihood of a loss contingency relating to the ultimate dispositions of any of these disputes is remote. When the likelihood of a loss contingency becomes at least reasonably possible with respect to any of these disputes, or, as applicable in the future, if there is at least a reasonable possibility that a loss exceeding amounts already recognized may have been incurred, we will revise our disclosures in accordance with the relevant authoritative guidance.

Additionally, the Company will accrue liability for loss contingencies when it believes that it is both probable that a liability has been incurred and that it can reasonably estimate the amount of the loss. The Company will review these accruals and adjust them to reflect ongoing negotiations, settlements, rulings, advice of legal counsel, and other relevant information. To the extent new information is obtained, and the Company's views on the probable outcomes of claims, suits, assessments, investigations, or legal proceedings change, changes in the Company's accrued liabilities would be recorded in the period in which such determination is made.

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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 the combination or integration of newly acquired services; the integration of Epocrates; the purchase of the Arsenal on the Charles campus; expected tax credits from states; 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 our service offerings, expected client implementations, expected certification and regulatory approvals and the benefits of our 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, 2012, 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.

Overview

athenahealth provides business services that help medical caregivers achieve and sustain financial health by collecting more money and exercising more control over their administrative and clinical tasks. These services are designed to reduce the administrative burden of complex billing rules, quality measurement and reporting, clinical documentation and data exchange, patient communication and referrals, and many of the related tasks that distract medical caregivers and staff from delivering care. Our services are delivered and consumed through a single instance of our cloud-based platform, athenaNet. We differentiate our services by regularly deploying updates and improvements through athenaNet to clients without any action on the part of the client. athenaNet enables us to quickly implement our solution at a low up-front cost and to seamlessly work in tandem with our clients in real time.

The services provided through our single-instance cloud are currently packaged as four integrated components: athenaCollector for revenue cycle management, athenaClinicals for electronic health record management, athenaCommunicator for patient communication management, and athenaCoordinator for referral cycle management. The use of our single-instance platform allows all clients to benefit from the collective knowledge of all of our other clients through our patented billing Rules Engine and our clinical Quality Management Engine. Our clients use these rules engines to monitor and benchmark their performance with peer practices across the network. Complementing athenaCollector is our cloud-based analytics service, athenaClarity, which delivers actionable insight in both fee-for-service and risk-based payment environments.

Each service we provide is supported by a model comprised of three distinct components: Software, Knowledge, and Work. The cloud-based software is provided at no extra charge to users but is the primary conduit through which we exchange information between clients, payers, and our staff of experts. Knowledge is infused into each of our services via our Rules Engine as we work with clients, payers, and other partners to codify rules associated with reimbursement, clinical quality measures, and other factors related to our clients' performance. The third component to

each of our services is the Work that we perform on behalf of our clients. Wherever possible, we replace manual processes with automation, but where automation is not possible, we provide that manual labor rather than returning it to clients to be completed. This unique service model of Software, Knowledge, and Work has allowed us to align our success with our clients' performance, creating a continual cycle of improvement and efficiency. We charge clients a percentage of collections in most cases, so our financial results are a direct reflection of our ability to drive revenue to medical practices.

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For the six months ended June 30, 2013, we generated revenue of \$271.9 million from the sale of our services compared to \$200.1 million for the six months ended June 30, 2012. Given the scope of our market opportunity, we have increased our spending each year on growth, innovation, and infrastructure.

Our revenue is predominately derived from business services that we provide on an ongoing basis. This revenue is generally determined as a percentage of payments collected by us on behalf of our clients, so the key drivers of our revenue include growth in the number of physicians and other medical providers working within our client accounts, the collections of these physicians, and the number of services purchased. To provide these services, we incur expenses in several categories, including direct operating, selling and marketing, research and development, general and administrative, and depreciation and amortization. In general, our direct operating expense increases as our volume of work increases, whereas our selling and marketing expense increases in proportion to our intended growth 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. We manage our cash and our use of credit facilities to ensure adequate liquidity, in adherence to related financial covenants.

Recent Developments

Watertown, MA Corporate Headquarters – Arsenal on the Charles

On May 10, 2013, we acquired the real estate commonly known as the Arsenal on the Charles, located in Watertown, Massachusetts. The Arsenal on the Charles is an expansive 29-acre, multi-building, commercial property where we were leasing our headquarters prior to the transaction. The purpose of this acquisition is to allow for future expansion of the corporate headquarters to accommodate anticipated headcount growth. The purchase price was \$168.5 million, subject to working capital adjustments. The fair value of the consideration paid was \$167.3 million, all of which was paid in cash. The acquisition of our Watertown, Massachusetts, corporate headquarters increased our total assets on the condensed consolidated balance sheet by approximately \$170 million, primarily due to increases in property and equipment of \$144.1 million and intangible assets of \$25.5 million. Total liabilities increased by approximately \$160 million due to increases in borrowings. See footnote 2 in the notes to the condensed consolidated financial statements for detailed information related to the business combination accounting.

Massachusetts Incentive Tax Credits

During the three months ended June 30, 2013, the Commonwealth of Massachusetts awarded us approximately \$9.5 million of Massachusetts investment tax credits over 10 years, subject to fulfillment of capital investment and jobs commitments by us. The award is subject to an agreement being reached between the Commonwealth of Massachusetts and us about the terms of the award. The agreement is expected to be reached in the three months ended September 30, 2013.

Epocrates, Inc.

On March 12, 2013, we acquired Epocrates, Inc. (“Epocrates”), a leading provider of essential clinical content, practice tools, and health industry engagement via mobile devices at the point of care. The Epocrates member network consists of more than one million health care professionals, including approximately 50% of U.S. physicians, who routinely use its solutions and services. Epocrates’ portfolio includes top-ranked medical applications, such as the industry’s #1 medical application among U.S. physicians, which provides convenient, point-of-care access to information such as dosing, drug interactions, pricing, and insurance coverage for thousands of brand, generic, and over-the-counter drugs. The features available through its unique physician platform are often referenced multiple times per day and help health care professionals make more informed prescribing decisions, improve workflow, and enhance patient safety. Epocrates offers its products on major U.S. mobile platforms, including Apple, Android, and BlackBerry. Epocrates generates revenue by providing clients in the health care industry (e.g., pharmaceutical companies, managed care companies, and market research firms) with interactive services to engage with its network of members and through the sale of subscriptions to its premium drug and clinical reference tools to health care professionals. Its client base is located almost entirely within the U.S. We acquired Epocrates for the assembled workforce, expected synergies, and accelerated awareness of athenahealth’s services across the physician market and to deliver high-value information to the clinical community.

The acquisition of Epocrates increased our total assets on the condensed consolidated balance sheet by approximately \$180 million, primarily due to increases in goodwill of \$148 million, purchased intangible assets of \$140 million and accounts receivable of \$23 million, which are offset by a decrease in cash of \$145 million. Total liabilities and stockholders' equity increased \$180 million, primarily due to increases in borrowings of \$105 million, net long-term deferred tax liabilities of \$40 million, deferred revenue of \$30 million, and a \$13 million increase in additional paid-in capital related to the equity portion of the fair value of consideration paid. See footnote 2 in the notes to the condensed consolidated financial statements for detailed information related to the business combination accounting.

Critical Accounting Policies

Our discussion and analysis of our results of operations and liquidity and capital resources are based on our condensed consolidated financial statements, which have been prepared in accordance with generally accepted accounting principles in the United States (“GAAP”). In connection with the preparation of our condensed consolidated financial statements in conformity with GAAP, we are required to make assumptions and estimates about future events and apply judgments that affect the reported amounts of assets, liabilities, revenue, expenses, and the related disclosures. We base our assumptions, estimates and judgments on historical experience, current trends and other factors we believe to be relevant at the time we prepare our condensed consolidated financial statements. On a regular basis, we review the accounting policies, assumptions, estimates and judgments to ensure that our condensed consolidated financial statements are presented fairly and in accordance with GAAP. However, because future events and their effects cannot be determined with certainty, actual results could differ from our assumptions and estimates, and such differences could be material.

Our condensed consolidated financial statements use estimates and assumptions that affect the reported amounts of assets and liabilities, 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) asset impairments; (3) estimated useful lives of assets; (4) fair value of stock options; (5) allocation of direct and indirect expenses; (6) fair value of contingent consideration and acquired intangible assets in a business combination; and (7) 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 condensed 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 business combinations related to purchased intangibles and contingent consideration. 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, 2012, as filed with the Securities and Exchange Commission on February 11, 2013.

Financial Operations Overview

Revenue. We derive our revenue from two sources: from business services associated with our revenue cycle management, electronic health record management, patient communication management, referral cycle management, analytics offerings, and from Epocrates; and from implementation and other services. Implementation and other revenue consists primarily of professional services fees related to assisting clients with the initial implementation of our services, for ongoing training and related support services, and for third-party tenant revenue. Business services accounted for 94% of our total revenues for the three months ended June 30, 2013 and 97% for the three months ended June 30, 2012. Business services accounted for 95% of our total revenues for the six months ended June 30, 2013 and 97% for the six months ended June 30, 2012. Business services revenue are 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. There is moderate seasonality in the activity level of physician practices. Typically, discretionary use of physician services declines in the late summer and during the holiday season, which leads to a decline in collections by our physician clients about 30 to 50 days later. Additionally, the volume of activity and related collections vary from year to year based in large part on the severity, length and timing of the onset of the flu season. While we believe that the severity, length and timing of the onset of the cold and flu season will continue to impact collections by our physician clients, there can be no assurance that our future sales of these services will

necessarily follow historical patterns. Implementation and other revenue 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 and six months ended June 30, 2013 and 2012.

Direct Operating Expense. Direct operating expense consists primarily of salaries, benefits, claim processing costs, other direct expenses, and stock-based compensation related to personnel who provide services to clients, including staff who implement new clients. We expense implementation costs as incurred. We include in direct operating expense all service costs associated with athenaCollector, athenaClinicals, athenaCommunicator, athenaCoordinator, athenaClarity, and Epocrates. We

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expect to increase our overall level of automation as we become a larger operation, with higher volumes of work in particular functions, geographies, and medical specialties. Although we expect that direct operating expense will increase in absolute terms for the foreseeable future, the direct operating expense is expected to decline as a percentage of revenue as we increase automation. 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 a portion of 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 expenses). Although we recognize substantially all of our revenue when services have been delivered, we recognize a large portion of our sales commission expense at the time of contract signature and at the time our services commence. Accordingly, we incur a portion of our sales and marketing expense prior to the recognition of the corresponding revenue. We have increased our sales and marketing expenses from year to year and we expect to continue to increase our investment in sales and marketing by hiring additional direct sales personnel and support personnel to add new clients and increase sales to our existing clients and to expand 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, in the near-term, sales and marketing expense will increase in line with revenue growth. Sales and marketing expense does not include allocated amounts for rent, occupancy and other indirect costs (including building maintenance and utilities), depreciation, and amortization, except for a portion of amortization related to purchased intangible assets.

Research and Development Expense. Research and development expense consists primarily of personnel-related expenses for research and development employees (including salaries, benefits, stock-based compensation, non-billable travel, lodging, and other out-of-pocket employee-related expenses) and consulting fees for third-party developers. We expect that, in the near-term, research and development expenditures will increase in absolute terms and will likely remain consistent as a percent of revenue as we develop and enhance new and existing services; however, the amount of expenditures that should be capitalized as software development costs versus expensed as research and development could vary based on the specific projects we undertake.

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; and, outside professional fees for accountants, lawyers, external costs associated with acquisitions, change in the fair value of contingent consideration, and consultants. We expect that general and administrative expense will increase in absolute terms as we invest in infrastructure to support our growth. Though expenses are expected to continue to rise in absolute terms, we expect general and administrative expense to decline as a percentage of total revenue over time.

Depreciation and Amortization Expense. Depreciation and amortization expense consists primarily of depreciation of fixed assets and amortization of capitalized software development and acquisition costs, which we amortize over a two to three-year period from the time of the release of the 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. In the near term, we expect depreciation and amortization expense to increase as a percentage of total revenue.

Interest Expense. Interest expense consists primarily of interest costs related to our term and revolving loans under our credit facility and the amortization of deferred financing fees.

Income Tax (Provision) Benefit. Income tax (provision) benefit consists of federal and state income taxes in the United States and India. The difference between our effective tax rate and our statutory rate is mainly related to transaction costs associated with stock acquisitions, any changes in the fair value of contingent consideration related to non-tax deductible goodwill, the treatment of Incentive Stock Options (“ISOs”), and the impact of certain tax deduction limits related to certain of our highly compensated officers. Transaction costs related to stock acquisitions are primarily non-tax deductible. The changes in the fair value of contingent consideration related to non-tax

deductible goodwill and the treatment of disqualifying dispositions related to ISOs are also treated as discrete items which means they are recorded in the quarter in which they occur and could cause significant differences between the quarterly and annual effective tax rate. Also, we substantially ceased issuing ISOs in 2009, but we expect continued volatility related to these options since we cannot anticipate when disqualifying dispositions related to these options will occur. We expect that our income tax provision for the fiscal year 2013 will be substantially lower than in prior years based on expected lower pretax income.

Results of Operations

Revenue. Total revenue for the three and six months ended June 30, 2013 is primarily due to an increase in business services revenue.

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Comparison of the Three and Six Months Ended June 30, 2013 and 2012

	Three Months Ended				Six Months Ended					
	June 30,		Change		June 30,		Change			
	2013	2012	Amount	Percent	2013	2012	Amount	Percent		
	(in thousands)									
Business services	\$137,919	\$100,110	\$37,809	38	%	\$259,382	\$193,659	\$65,723	34	%
Implementation and other	8,382	3,405	4,977	146	%	12,515	6,422	6,093	95	%
Total	\$146,301	\$103,515	\$42,786	41	%	\$271,897	\$200,081	\$71,816	36	%

Business Services Revenue. The increase in business services revenue is primarily driven by the growth in the number of physicians and providers using our services, including Epocrates. The three and six months ended June 30, 2013 includes \$14.6 million and \$20.1 million of total revenue, respectively, attributable to Epocrates business service revenue. The increases in the number of physicians and providers using our revenue cycle management service, athenaCollector; electronic health record management service, athenaClinicals; and patient communication management service, athenaCommunicator; are as follows:

As of June 30,
2013 2012