HEARX LTD
Form 10-K
March 23, 2001

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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K

FOR ANNUAL AND TRANSITION REPORTS
PURSUANT TO SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934

(MARK ONE)

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE FISCAL YEAR ENDED DECEMBER 29, 2000

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 0-16453

HEARx LTD.

EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER

DELAWARE	22-2748248
(STATE OF OTHER JURISDICTION INCORPORATION OR ORGANIZATION)	(I.R.S. EMPLOYER IDENTIFICATION NO.)

1250 NORTHPOINT PARKWAY, WEST PALM BEACH, FLORIDA	33407
(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES)	(ZIP CODE)

REGISTRANT'S TELEPHONE NUMBER, INCLUDING AREA CODE (561) 478-8770

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT:

TITLE OF EACH CLASS	NAME OF EACH EXCHANGE ON WHICH REGISTERED
COMMON STOCK, PAR VALUE .10 PER SHARE	AMERICAN STOCK EXCHANGE

SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT: NONE

INDICATE BY CHECK X WHETHER THE REGISTRANT (1) HAS FILED ALL REPORTS REQUIRED TO BE FILED BY SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 DURING THE PRECEDING 12 MONTHS (OR FOR SUCH SHORTER PERIOD THAT THE REGISTRANT WAS REQUIRED TO FILE SUCH REPORTS), AND (2) HAS BEEN SUBJECT TO SUCH FILING REQUIREMENTS FOR THE PAST 90 DAYS YES X NO

INDICATE BY CHECK X IF DISCLOSURE OF DELINQUENT FILERS PURSUANT TO ITEM 405 OF REGULATION S-K IS NOT CONTAINED HEREIN AND WILL NOT BE CONTAINED, TO THE BEST OF THE REGISTRANT'S KNOWLEDGE, IN DEFINITIVE PROXY OR INFORMATION STATEMENTS INCORPORATED BY REFERENCE IN PART III OF THIS FORM 10-K OR ANY AMENDMENT TO THIS FORM 10-K. [ ]

AS OF MARCH 21, 2001, THE AGGREGATE MARKET VALUE OF THE REGISTRANT'S COMMON STOCK HELD BY NON-AFFILIATES (BASED UPON THE CLOSING PRICE OF THE COMMON STOCK ON THE AMERICAN STOCK EXCHANGE) WAS APPROXIMATELY $21,161,690.

ON MARCH 21, 2001, 12,825,267 SHARES OF THE REGISTRANT'S COMMON STOCK WERE OUTSTANDING.

DOCUMENTS INCORPORATED BY REFERENCE

PORTIONS OF REGISTRANT'S DEFINITIVE PROXY STATEMENT FOR THE 2001 ANNUAL MEETING OF THE REGISTRANT'S STOCKHOLDERS ("2001 PROXY STATEMENT"), TO BE FILED WITH THE SECURITIES AND EXCHANGE COMMISSION, ARE INCORPORATED BY REFERENCE IN PART III HEREOF.

PART I

ITEM 1. BUSINESS

HEARx Ltd. ("HEARx" or the "Company") operates a network of hearing care centers which provide a full range of audiological products and services for the hearing impaired. The Company's strategy for continuing and accelerating the centers' sales growth and market penetration includes aggressively advertising to the non-insured self-pay market and positioning the Company as the leading provider of hearing care to the managed care marketplace. The Company believes it is well positioned to successfully address the concerns of access, quality and cost for the patients of managed care and other health insurance companies, diagnostic needs of referring physicians and, ultimately, the hearing health needs of consumers. HEARx believes that such success requires the Company to offer convenient distribution points, uniform centers (meaning standardized personnel qualification, testing, formats, products, prices and ancillary services) and a documented quality control program.

HEARx and its subsidiary HEARx West LLC, a joint venture with the

Permanente Federation LLC, currently receive a per-member-per-month fee for more than 1.3 million managed care members. In total, HEARx has over 170 contracts for hearing care with various healthcare providers. The Company has increased its attention to the self-pay market, focusing an aggressive advertising and marketing program directed to the uninsured patient. The Company intends to increase its sales to these patients, while creating greater awareness of the Company by the managed care patients covered by contracts with HEARx. To the extent the Company is successful in contracting with the providers of Medicare managed care for the provision of hearing care goods and services, the Company can enjoy the benefits of the continuing shift of Medicare patients to managed care.

HEARx was incorporated in Delaware on April 11, 1986.

FACILITIES AND SERVICES

Each HEARx center is staffed or supervised by a minimum of one professionally trained, licensed and certified audiologist and at least one patient care coordinator. The majority of the Company's centers are located in conveniently accessible strip shopping centers and are typically 1,500 to 2,500 square feet in size. The Company's goal is to have all centers virtually identical in interior space design, exterior marking and signage. This uniform appearance helps reinforce the consistent service and quality the Company strives to provide to patients at all locations. Each center provides comprehensive hearing services that include:

- A facility equipped with soundproof testing booths and state-of-the-art testing equipment that meets or exceeds all state standards.

- A full range of diagnostic and auditory-vestibular tests that assist the physician in the treatment of patients with hearing and balance disorders. Some of these services include auditory brainstem evoked potentials, electronystagmography and immittance audiometry.

- A family hearing counseling program available to all patients to help them better understand the use of their hearing products and their disability.

- A wide variety of hearing aid brands to meet patient needs.

- A standardized medical reporting system for feedback to the referring physicians.

PRODUCTS

HEARx has selected an assortment of major worldwide manufacturers' products to make available through the HEARx network in order to provide the best possible hearing care for HEARx patients, including the latest digital technology.

In addition, all HEARx centers offer a large selection of other hearing enhancement devices including telephone and television amplifiers, telecaptioners and decoders, pocket talkers, specially adapted telephones, alarm clocks, doorbells and fire alarms.

CUSTOMERS AND MARKETING

The Company believes that its future growth depends in part on its ability to inform hearing impaired consumers of the importance of professional hearing testing and of the availability of quality hearing devices. The Company expects to continue to establish relationships with health organizations and physicians that promote HEARx to the hearing impaired.

Because HEARx believes that hearing loss is a medical problem and not simply a retail opportunity, the Company encourages all patients to see a physician prior to purchasing a hearing aid. The Company believes it has established strong relationships with area physicians, which represent a significant source of continuing patient referrals. HEARx further maintains these relationships using its computerized medical reporting system to provide each referring physician a full report on each of their patients' visits to HEARx.

HEARx's marketing plan focuses on educating both physicians and patients on the need for regular hearing testing and the importance of hearing aids and other assistive listening devices in improving the quality of life for hearing impaired individuals. The Company works to further its image as a provider of highly professional services, quality products, and comprehensive post-sale consumer education. In connection with its marketing program, HEARx has developed a direct consumer marketing campaign, which utilizes television, radio, newspaper and magazine advertisements, direct mailings, and company-operated free seminars on hearing and hearing loss.

During the year ended December 29, 2000, the Company formed two strategic marketing partnerships, one with TIME Magazine and one with Reader's Digest. As part of each program, patients visiting HEARx centers will be offered an opportunity to take advantage of a special promotion of these magazines. Subscribers of each of these magazines will receive a discount at HEARx when purchasing a hearing aid in addition to a free one-year subscription to TIME or a two year subscription to Reader's Digest Large Print Edition.

HEARx will be promoting Reader's Digest Large Print Edition in the HEARx network of hearing care centers and in its patient mailings. Reader's Digest Large Print will be including a special offer from HEARx to current subscribers of Reader's Digest Large Print Edition. HEARx will also receive a special credit for use in advertising in Reader's Digest Large Print Edition. Reader's Digest Large Print currently reaches over 500,000 people each month, with more than 35 percent residing in areas currently serviced by HEARx.

The Company also launched a new website, HEARx.com, which was designed to increase patient referrals to HEARx centers. The website contains educational material regarding hearing loss and the different types of hearing aids directed to the adult children of potential patients. The Company plans to offer for purchase on the website various hearing enhancement devices designed for the hearing impaired, such as smoke detectors and alarm clocks.

The Company has developed a national call center, which began beta testing for five Florida centers in mid-November 2000. As of March 19, 2001 there are nineteen centers utilizing the call center. The national call center will be responsible for both inbound and outbound

marketing. The call center was designed to increase the effectiveness of advertising, and is expected to be fully operational by July 2001.

For the fiscal years 2000, 1999 and 1998, HEARx reported revenues of $56,408,964, $47,686,868 and $27,493,849, respectively. During 1999, the Company did not have sales totaling 10% or more of total net sales to a single customer. In 2000 and 1998, the Company had sales of 10% or more of consolidated revenues to a single customer of approximately $5.7 million and $3.3 million, or 10.1% and 12.7%, respectively, to Kaiser Permanente Health Plan and Health Options.

OPERATIONS

Company-owned Centers

At the end of 2000, the Company operated a total of 80 centers located in Florida, New York, New Jersey and in California (through HEARx West). The Company's long term goal, where the population warrants, is to open "clusters" of four to six Company-owned centers within a city or county in the Company's primary markets in order to take advantage of certain operational and marketing efficiencies created by having multiple locations within a particular region. These efficiencies relate principally to advertising and marketing of the centers as well as to personnel recruiting and supervision for the centers.

Joint Venture

During August 1998, HEARx formed a joint venture, HEARx West LLC, with the Permanente Federation LLC to create and operate a network of retail centers to serve the needs of the hearing impaired principally in California. The joint venture agreement provides for a 50/50 ownership by HEARx and the Permanente Federation, with the centers bearing the HEARx name. HEARx is responsible for the daily operation of the centers, however all clinical and quality issues are the responsibility of a joint committee comprised of HEARx and Permanente clinicians.

During 2000 and 1999, HEARx West centers concentrated on providing hearing aids and diagnostic audiology testing to Kaiser Permanente's members and self- pay patients in the state of California. During 2001, HEARx West will also seek contracts to provide services to members of other managed care organizations and self-pay patients. At the end of 2000, HEARx operated 19 HEARx West centers in southern California. HEARx West has the first right of refusal for any geographic expansion opportunities for new HEARx centers, excluding expansion in the states of Florida, New Jersey and Pennsylvania, which shall remain exclusively with HEARx Ltd.

Managed Care and Institutional Contracts

Since the beginning of 1991, the Company has entered into arrangements with institutional buyers relating to the provision of hearing care products and services. HEARx believes that contractual relationships with institutional buyers of hearing aids are essential. These institutions include managed care companies, health maintenance organizations, insurance companies, senior citizen buying groups and unions. By developing contractual arrangements for the referral of patients, marketing costs are reduced, and relationships with local area physicians are enhanced. Critical to providing care to members of these groups is the availability of distribution sites, quality control and the standardization of products and services. The Company believes its system of high quality, uniform centers meets the needs of the patients and their providers.

HEARx enters into provider agreements with health insurance or managed care organizations for the furnishing of hearing care on three different bases: (a) fee for service basis based on a contractual rate offered by HEARx to provider's members (all paid for by the patient); (b) a per capita basis, which is a fixed payment per patient per month from the provider to HEARx, determined by the number of patients to be served and the amount to be paid by the insurance or managed care organization (the balance is paid by the individual member); or (c) an encounter basis where the Company is paid a fixed fee by the insurance or managed care organization for each hearing aid sold (with the balance paid to HEARx by the individual member).

RENEWAL OF AGREEMENTS WITH HEALTH INSURANCE AND MANAGED CARE ORGANIZATIONS

The terms of most of these agreements are to be renegotiated annually, and most of these agreements may be terminated by either party on 90-days notice at any time. The early termination of or failure to renew the agreements could adversely affect the operation of the hearing care centers located in the related market area. In addition, the early termination of or failure to renew the agreements which provide for payment to the Company on a per capita basis would cause the Company to lower its estimates of revenues to be received over the life of the agreements and could have an adverse effect on the Company's results of operations. The Company is not aware of any likely contract terminations at this time.

Effective for both January 1, 2000 and 2001, several insurance companies with which the Company has contracts significantly changed their contract benefits or service areas. While some insurance companies increased their Medicare benefits, others either limited or discontinued hearing benefits for Medicare patients. The Company believes these changes will not have a long-term material adverse effect on the Company's financial condition or results of operations. The Company also believes that the loss of any single managed care contract will not have a long term material adverse effect on its financial condition or results of operations.

DISTINGUISHING FEATURES

Integral to the success of HEARx's strategy is the strengthening of consumer's confidence in the hearing care industry and the differentiation of HEARx from its competitors. To that end, the Company has accomplished several unique objectives, which are highlighted below.

Joint Commission on Accreditation of Healthcare Organizations (JCAHO)

During 1998, the Company distinguished itself from other hearing care providers by being awarded a three year accreditation, effective June 2, 1998, from the Joint Commission on Accreditation of Healthcare Organizations (JCAHO). The Company plans to apply for renewal of this accreditation. To achieve accreditation, the Company was required to meet national standards addressing the rights and responsibilities of persons enrolled in the network; organizational ethics; providing a continuum of care; educating and communicating with enrollees; leadership; management of information; and improving network performance.

Scientific Advisory Board

HEARx has formed a Scientific Advisory Board consisting of some of the leading experts in otolaryngology and audiology in an effort to instill consumer confidence. Each of the five members of the Scientific Advisory Board is a highly trained professional with extensive experience in the hearing field and is affiliated with a prestigious university and/or institution. Company officials consult with members of this Board to keep the Company abreast of developments in otolaryngology and audiology and for advice as to the Company's overall business strategy. Additionally, the Scientific Advisory Board meets annually to review corporate planning and discuss improvements in any of the services or products which the Company offers. The Scientific Advisory Board also advises the Company with respect to the introduction of new or improved services or products, assists the Company in developing and reviewing quality assurance programs, and advises the Company as to the effect of any proposed or existing regulatory activity upon customers of the Company.

The current members of the Scientific Advisory Board and field with respect to which each consults with the Company are listed below:

Hearing Testing
James Jerger, Ph.D.
Professor of Audiology
University of Texas at Dallas
Dallas, TX

Patient Satisfaction and Outcomes
Lucille Beck, Ph. D.
Director of Audiology and Speech Pathology Services
VA Medical Center
Washington, D.C.

Medical Relations
Bruce J. Gantz, M.D.
Department Chairman of Otolaryngology
University of Iowa Hospitals and Clinics
Iowa City, IA

Hearing Aids and Devices
Charles I. Berlin, Ph.D.
Professor of Otorhinolaryngology & Biocommunications
Louisiana State University

Director, Kresge Hearing Research Laboratory of the South
New Orleans, Louisiana

Professional and Government Relations
Derald Brackmann, M.D.
House Ear Clinic, Inc.

Clinical Professor of Otolaryngology
University of Southern California
Los Angeles, California

Medical Reporting and HEARx Data Link

A computerized medical reporting system gives referring physicians the results of, and recommended action for, every patient examined by HEARx. To the Company's knowledge, no other dispenser or audiologist presently offers any referring physician similar computerized documentation. The Company believes that as hearing acuity and correction become an expected part of an individual's health profile, accurate records of past audiological test results, prescriptions and pathology should be available and accessible to those treating the patient. To address this need, the Company has developed a centralized computer data storage and retrieval system which provides information compiled from each HEARx center visit.

COMPETITION

The hearing care industry is highly fragmented with approximately 11,000 practitioners providing testing and dispensing products and services. Roughly 3,000 of these practitioners are audiologists working for hospitals or physicians, 3,000 of the practitioners are licensed audiologists in private practice, and the remaining 5,000 are hearing aid specialists . Industry surveys estimate that approximately 5% of all hearing aids are sold in physicians' offices, 60% are dispensed by qualified audiologists in private practice, and the remaining 35% are sold by hearing aid specialists.

The hearing services arena is a fragmented industry with little standardization among the independent providers. It is difficult to determine the precise number of competitors of the Company in every market where the Company has operations, or the percentage of market share enjoyed by the Company.

Some competitors are large distributors, including: (1) Amplifon of Italy, which owns a national network of over 1,000 franchised stores (Miracle Ear) including 400 located in Sears Roebuck & Co. stores; and (2) Beltone Electronics Corp., a hearing aid manufacturer owned by Great Nordic Corp. that distributes its products primarily through its network of approximately 700 "authorized" distributors. A number of these franchises and distributors are located in the areas the Company serves.

These networks offer hearing aids and may not provide comprehensive diagnostic services, or other ancillary products offered by the Company. These networks are owned by companies having greater resources than the Company, and there can be no assurance that one or more of these competitors will not expand and/or change their operations to capture the market targeted by the Company. Nor can there be any assurance that the largely fragmented hearing care market cannot be successfully consolidated by the establishment of co-operatives, alliances, confederations or the like which would then compete more directly with HEARx in its marketing strategy.

RELIANCE ON MANUFACTURERS AND QUALIFIED HEARING PROFESSIONALS

Through its hearing care centers, HEARx makes hearing aids available to patients which are supplied by approximately five major manufacturers, as well as hearing enhancement devices manufactured by other companies. The Company relies on these manufacturers to supply such products, and a significant disruption in supply from any or all of these manufacturers could adversely affect the Company's business. In the event of a disruption of supply from one or more of the Company's current suppliers, the Company could obtain comparable products from other manufacturers. Few manufacturers offer dramatic product differentiation. The Company has not experienced any significant disruptions in supply in the past.

The Company currently employs 160 licensed hearing professionals, of which 133 are audiologists. The inability of the Company to attract and retain qualified licensed hearing professionals would reduce the Company's ability to distinguish itself from competing networks of hearing aid retailers and thus adversely affect its business. Management believes that it will be able to attract and retain qualified licensed hearing professionals sufficient to staff its centers for the foreseeable future.

REGULATION

Federal

The practice of audiology and the dispensing of hearing aids are not presently regulated on the Federal level. The United States Food and Drug Administration ("FDA") is responsible for monitoring the hearing care industry. Currently there are only two regulations affecting the sale of hearing aids: 1) a physician's review and 2) a return policy. The FDA requires first time hearing aid purchasers to receive medical clearance from a physician prior to purchase; however, patients may sign a waiver in lieu of a physician's examination A majority of the patients in HEARx centers are members of the managed care or institutional providers with whom HEARx has contracts to provide hearing care. Some of these organizations require a physician referral. Consequently, a new federal or state physician referral mandate should not have an adverse impact on the Company's operations. The FDA has mandated that states adopt a return policy for consumers offering them the right to return their products, generally within 30 days. HEARx offers all its customers a full 30-day return period and extends the return period to 60 days for patients who participate in the free HEARx Educational Listening Program (H.E.L.P.) family hearing counseling program.

In addition, because the Company's centers accept Medicare and Medicaid patients, the centers must maintain their eligibility as Medicare/Medicaid providers and must comply with related federal anti-fraud, and other applicable regulations. Federal laws prohibit the payment of remuneration ("kickbacks") in return for a physician referring a Medicare or Medicaid patient, and those laws limit physicians from referring patients to providers in which they have a financial interest. The Company believes that none of its managed care or other provider contracts or its relationships with referring physicians are violative of the anti-kickback statute.

The Company cannot predict the effect of future changes in federal laws, including changes which may result from proposals for federal health care reform legislation being considered by the U.S. Congress, or the impact that changes in existing federal laws or in the interpretation of those laws might have on the Company. The Company believes it is in material compliance with all existing federal regulatory requirements.

State

Generally, state regulations, where they exist, are concerned primarily with the formal licensure of audiologists and of those who dispense hearing aids and with practices and procedures involving the fitting and dispensing of hearing aids. There can be no assurance that regulations do not exist in jurisdictions in which the Company plans to open centers or will not be promulgated in states in which the Company currently operates centers which may have a material adverse effect upon the Company. Such regulations might include stricter licensure requirements for dispensers of hearing aids, inspections of centers for the dispensing of hearing aids and the regulation of advertising by dispensers of hearing aids. The Company knows of no current or proposed state regulations with which it, as currently operated, could not comply.

The Company believes it is in material compliance with all applicable state regulatory requirements.

PRODUCT AND PROFESSIONAL LIABILITY

In the ordinary course of its business, HEARx may be subject to product and professional liability claims alleging the failure of, or adverse effects claimed to have been caused by, products sold or services provided by the Company. The Company maintains insurance at a level which the Company believes to be adequate. A successful claim in excess of the policy limits of the Company's liability insurance could adversely affect the Company. As the distributor of products manufactured by others, the Company believes it would properly have recourse against the manufacturer in the event of a product liability claim; however, there can be no assurance that

recourse against a manufacturer by the Company would be successful or that any manufacturer will maintain adequate insurance or otherwise be able to pay such liability.

SEASONALITY

The Company is not generally affected by seasonality.

EMPLOYEES

At December 29, 2000, HEARx Ltd. had approximately 375 full-time employees, of which 81 were employed by HEARx West.

The operations of the Company are dependent in large part upon the efforts of Paul A. Brown, M.D., Chairman of the Board and Chief Executive Officer, and Stephen J. Hansbrough, President, Chief Operating Officer and Director. The loss of the services of Dr. Brown or Mr. Hansbrough could adversely affect the conduct and operation of the Company's business. The Company purchased a "key man" insurance policy on Dr. Brown's life in the amount of $3,000,000 for the benefit of the Company.

ITEM 2. PROPERTIES

HEARx's corporate offices are located in 13,000 square feet of space in West Palm Beach, Florida. The lease is for five years and expires May 2006.

As of December 29, 2000, the Company operated 33 centers in Florida, 15 in New Jersey and 13 in New York and 19 HEARx West centers in California. All of the locations are leased for one to ten year terms pursuant to generally non-cancelable leases (with renewal options in some cases). Each center consists of between 700 and 3,000 square feet with annual base rents ranging from approximately $8,700 to $76,000. In January 1999, the Company closed twelve centers in the northeast. The Company has successfully negotiated and completed lease buy-outs, exercised early termination options or subleases on eleven of the twelve properties.

The Company believes its facilities are adequate and suitable for its current operations.

ITEM 3. LEGAL PROCEEDINGS

None.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None

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EXECUTIVE OFFICERS OF THE COMPANY

The following sets forth certain information as of the date hereof with respect to the Company's executive officers. Each of Dr. Brown and Mr. Hansbrough are serving pursuant to employment agreements with 5 year terms expiring in 2004 unless renewed or extended. Mr. Peklenk and Ms. Taylor each has been appointed to a term which will expire at the annual meeting of Board of Directors held at the time of the 2001 Annual Meeting of Stockholders, or at the time his/her successor is duly elected and qualified:

NAME AND POSITION	AGE	FIRST SERVED AS EXECUTIVE OFFICER
Paul A. Brown, M.D. Chairman of the Board Chief Executive Officer	62	1986
Stephen J. Hansbrough President, Chief Operating Officer and Director	53	1993
James W. Peklenk Vice President - Finance and Chief Financial Officer	55	1996
Donna L. Taylor Senior Vice President Sales & Operations	44	2000

There are no family relationships among any of the executive officers and directors of the Company.

Paul A. Brown, M.D., holds an A.B. from Harvard College and a M.D. from Tufts University School of Medicine. From 1970 to 1984, Dr. Brown was Chairman of the Board and Chief Executive Officer of MetPath Inc. ("MetPath"), a New Jersey-based corporation offering a full range of clinical laboratory services to physicians and hospitals, which he founded in 1967 while a resident in pathology at Columbia Presbyterian Medical Center in New York City. MetPath developed into the largest clinical laboratory in the world with over 3,000 employees and was listed on the American Stock Exchange prior to being sold to Corning Glass Works in 1982. Dr. Brown founded HEARx in 1986. Dr. Brown is formerly Chairman of the Board of Overseers of Tufts University School of Medicine, an Emeritus member of the Board of Trustees of Tufts University, a past member of the Visiting Committee of Boston University School of Medicine and part-time lecturer in pathology at Columbia University College of Physicians and Surgeons.

Stephen J. Hansbrough, President, Chief Operating Officer and Director, was formerly the Senior Vice President of Dart Drug Corporation and was instrumental in starting their affiliated group of companies (Crown Books and Trak Auto). These companies along with Dart Drug Stores had over 400 retail locations, generated approximately $550 million in annual revenues and employed over 3,000 people. Mr. Hansbrough subsequently became Chairman and CEO of Dart Drug Stores with annual revenues in excess of $250 million. After leaving Dart, Mr. Hansbrough was an independent consultant specializing in turnaround and start-up operations, primarily in the retail field, until he joined HEARx in December 1993.

James W. Peklenk, Vice President - Finance and Chief Financial Officer, joined the Company in November 1995 as Controller and became Vice President - Finance and Chief Financial Officer in June 1996. He has a B.S. in Accounting from the University of Louisville. From 1991 until joining HEARx, Mr. Peklenk was Vice President, Finance/CFO, for Shooters International, Inc., an international restaurant operator and franchiser of Shooters Waterfront Cafes. Prior thereto, Mr. Peklenk was Director of Internal Audit for Chi-Chi's Mexican Restaurants, and before that an Audit Partner with the international accounting firm of Grant Thornton.

Donna L. Taylor, Senior Vice President Sales and Operations, joined HEARx in July 1987 as an audiologist. She was later promoted to Area Manager and Director of Operations for the Company in Florida. She assumed her role as Vice President Sales and Operations in December 1993 and in October 2000 was promoted to Senior Vice President - Sales and Operations. Prior to employment by HEARx, she practiced as an audiologist. Ms. Taylor received her B.S. from the University of Iowa in May 1979, her M.A. from the University of Iowa in May 1981, and earned her CCC (Certificate of Clinical Competency) in March 1982.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

The following table sets forth the high and low sales prices of the Common Stock as reported by the American Stock Exchange (AMEX), ticker symbol EAR, for the fiscal quarters indicated. On June 30, 1999 the Company effectuated a one for ten reverse common stock split. The reverse stock split and a reduction in the authorized shares of common stock to twenty million shares were approved at the June 7, 1999 Annual Meeting of Stockholders. Accordingly, the Company has restated all share and per share data for all periods presented to reflect the change in capital structure.

Fiscal Quarter	Common Stock	
	High	Low

1999		
First	$ 7 1/2	$ 5
Second	5 5/8	4 3/8
Third	5 3/8	4 3/8
Fourth	4 7/8	3 9/16
2000		
First	$ 6 7/16	$ 4 1/16
Second	4 1/4	3 9/16
Third	3 3/4	2 9/16
Fourth	2 13/16	1 1/16

As of March 14, 2001, there were 1,081 holders of record of the Common Stock. The Company estimates that included within the holders of record are approximately 17,300 beneficial owners of the Common Stock.

Dividend Policy

HEARx has never paid and does not anticipate paying any dividends on the Common Stock in the foreseeable future but intends to retain any earnings for use in the Company's business operations.

Under the terms of the Company's 7% Series I Convertible Preferred Stock, the Company may not directly or indirectly pay or declare any dividend or make any distribution (other than a dividend or distribution described in the purchase agreement or dividends due and paid in the ordinary course on preferred stock of the Company at such times when the Company is in compliance with its payment and other obligations). No distribution shall be made with respect to any Junior Securities, or no more than $500,000 may be set aside for or applied to the purchase or redemption (through a sinking fund or otherwise) of any Junior Securities or shares pari passu with the Preferred Stock while shares of the Preferred Stock are outstanding.

ITEM 6. SELECTED FINANCIAL DATA

The following selected financial data of the Company should be read in conjunction with the consolidated financial statements and notes thereto and the following Management's Discussion and Analysis of Financial Condition and Results of Operations. The financial data set forth on the next two pages have been derived from the audited consolidated financial statements of the Company:

OPERATING STATEMENT DATA:

	Year Ended			
	December 29 2000	December 31 1999(1)	December 25 1998	Dec
Net Revenues	$56,408,964	$ 47,686,868	$ 27,493,849	$ 2
Total costs and expenses	59,725,542	52,038,441	39,222,091(2)	3
Loss before minority interest and equity in loss of joint venture	(3,316,578)	(4,351,573)	(11,728,242)	(
Minority Interest	-	347,677		
Equity in loss of joint venture	-	-	(615,420)	
Net Loss	(3,316,577)	(4,003,896)	(12,343,662)	(
Dividends on preferred stock	(1,346,872)	(821,387)	(587,893)	(
Net loss applicable to common stockholders	$ (4,663,450)	$ (4,825,283)	$(12,931,555)	$(1
Loss per common share: Basic and diluted, including dividends on preferred stock	$ (0.39)	$ (0.45)	$ (1.28)	$
Weighted average number of common shares outstanding	11,834,388	10,775,006	10,126,979	
Cash dividends per common Share	None	None	None	

(1) As discussed in Note 1 to the Consolidated Financial Statements, during 2000 and 1999 the Company's Consolidated Financial Statements include the accounts of HEARx West, its 50% subsidiary.

(2) During December 1998, the Company recorded a restructure charge of $2,233,857 in connection with the closing of 12 centers in the northeast in January 1999.

BALANCE SHEET DATA:

			As of	
	December 29	December 31	December 25	Decemb
	2000	1999	1998	199
Total assets	$21,872,123	$21,377,110	$25,208,317	$28,35
Working capital	2,350,834	938,815	7,614,042	13,13
Long-term debt, net of current portion	175,887	322,332	123,316	17

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ITEM 7. MANAGEMENT'S DISCUSSION OF RESULTS OF OPERATIONS AND ANALYSIS OF FINANCIAL CONDITION

GENERAL

The Company's strategy for continuing and accelerating center sales growth and market penetration includes both aggressively advertising to the non-insured self-pay or retail market and positioning the Company as the leading provider of hearing care to the benefited populations covered by managed care contracts.

HEARx intends, as its long-term goal, to establish a nationwide network of hearing care centers, located in the metropolitan areas or regions with concentrations of elderly consumers who are more likely to need the Company's products and services. The Company is currently expanding its hearing care center network through its joint venture, HEARx West LLC, in California. The joint venture agreement provides for a 50/50 ownership by the Company and the Permanente Federation and its affiliate Kaiser Foundation Health Plan, with the centers bearing the HEARx name. For the year ended December 29, 2000, the Company operated 19 of these centers in California.

During the year ended December 29, 2000, the Company formed two strategic marketing partnerships, one with TIME Magazine and one with Reader's Digest. As part of each program, patients visiting HEARx centers will be offered an opportunity to take advantage of a special promotion of these magazines. Subscribers of these magazines will receive a discount at HEARx when purchasing a hearing aid in addition to a free one-year subscription to TIME or a two-year subscription to Reader's Digest Large Print Edition.

The Company also launched a new website, HEARx.com, which was designed to increase patient referrals to HEARx centers. The website contains educational material regarding hearing loss and types of hearing aids directed to the adult children of potential patients. The Company plans to offer for purchase on the website various hearing enhancement devices designed for the hearing impaired such as smoke detectors and alarm clocks.

The Company has developed a national call center, which began beta testing for five Florida centers in mid-November. As of March 19, 2001 there are nineteen centers utilizing the call center. The national call center will be responsible for both inbound and outbound marketing. The call center was designed to increase the effectiveness of advertising, and is expected to be fully operational by July 2001.

Effective January 1, 2000, Florida Health Choice of southeast Florida and United Healthcare of New Jersey discontinued providing hearing care benefits to Medicare participants. Total revenue generated from these plans in 1999 was approximately $692,000. In addition, several other insurance companies with which the Company has contracts with, significantly changed their contract benefits or service areas. The Company believes these changes will not have a material effect on the Company's financial condition or results of operations. The Company also believes that the loss of any single managed care contract will not have a long term material adverse effect on its financial condition or results of operations.

RESULTS OF OPERATIONS

2000 COMPARED TO 1999

Net revenues increased $8,722,096, or 18.3%, to $56,408,964 in 2000 from $47,686,868 in 1999. Net revenues by region for the Northeast, Florida and California were approximately $14.2 million, $24.0 million, and $18.0 million, respectively, in 2000 as compared to $10.1 million, $25.0 million and $12.4 million, respectively in 1999. Most of this increase resulted from an increase in same store sales of 17.2%. The increase in net revenues resulted from, the increase of revenues from HEARx West and the Northeast, and an increase in the retail business arising from the Company's continued aggressive advertising campaign resulting in an increase in revenues from the non-insured self-pay market of $11,818,235, or 46.9% from $25,158,339 in 1999 to $36,976,574 in 2000.

Cost of products sold increased $4,354,826, or 29.8%, to $18,966,110 in 2000 from $14,611,284 in 1999. Part of the increase in the cost of products sold is a direct result of the 46.9% increase in revenues from the self-pay market due to increased sales of hearing aids with advanced digital technology which generally resulted in lower margins.. During 2000, the Company experienced an increase in the sales level of digital hearing aids, however the Company cannot be assured that this trend will continue in the year 2001. The cost of products sold as a percent of net revenues, which was 33.6% and 30.6% for the year ended 2000 and 1999, respectively, fluctuates from period to period due to retail pricing and changing marketing strategies.

Center operating expenses increased $2,951,284, or 11.2%, to $29,328,114 in 2000 from $26,376,830 in 1999. The Company continued to intensify its aggressive marketing program, increasing center advertising expense to $7,161,400, or 12.7% of revenue, up from $5,063,216, or 10.6% of revenue in 1999. In addition due to the increase in revenues, the Company increased its number of employees from 360 in 1999, to 375 in 2000. This resulted in an increase of salaries and wages of approximately $763,000. Center operating expenses as a percent of revenue decreased to 51.9% in 2000, from 55.3% in 1999 as a result of opening one new center in July 2000 offset by the 17.2% increase in same store sales. Center operating earnings (excluding corporate general and administrative expenses and depreciation, amortization) increased $1,415,986, or 21.1%, to $8,114,740 in 2000 from $6,698,754 in 1999.

General and administrative expenses increased $228,823 to $8,830,546 in 2000 from $8,601,723 in 1999. General and administrative expenses as a percent of net revenue decreased to 15.7% in 2000 from 18.0% in 1999. This increase is partially due to the increase of $610,868 in wages and fringe benefits associated with the expansion of corporate administrative functions, which includes the implementation of the national call center, offset by the decrease in shareholder relations and general insurance expense of approximately $127,000 and $143,000, respectively.

Depreciation and amortization expense increased $151,157, or 6.2%, to $2,572,048 in 2000 from $2,420,891 in 1999. This increase is attributable to the increase of depreciable assets due to the opening of 16 additional HEARx West centers in California in 1999 and 1 in July 2000, and the relocation of 5 centers within Florida during 2000.

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1999 COMPARED TO 1998

Prior to March 1999, HEARx Ltd. accounted for its investment in HEARx West using the equity method because HEARx did not control HEARx West due to certain provisions in the joint venture agreement. During 1999, as a result of amendments to the agreement, HEARx obtained control of HEARx West. Accordingly, during 1999, HEARx included the financial position and results of operations of HEARx West in its consolidated financial statements.

Net revenues increased $20,193,019, or 73%, to $47,686,868 in 1999 from $27,493,849 in 1998. The consolidation of HEARx West revenues contributed approximately $12,446,000 to the increase. The Company's aggressive advertising campaign during 1999 yielded revenues from self-pay patients of approximately $16,457,000, which was partially offset by the closing of the 12 northeast centers in January 1999, which accounted for $1,228,000 of 1998 revenues.

Cost of products sold increased $6,418,226, or 78%, to $14,611,284 in

1999 from $8,193,058 in 1998. Approximately $4,452,000 of the increase is a result of the consolidation of HEARx West. The remainder of the increase is attributable to the increase in sales from existing centers. The cost of products sold as a percent of net revenues, which was 31% and 30 % for 1999 and 1998, respectively, fluctuates from period to period depending generally upon the sales mix and sales promotions. However, HEARx West provided a higher cost of sales percentage at 36%, because a fixed discount has been granted to Kaiser members.

Center operating expenses increased $6,406,335, or 32%, to $26,376,830 in 1999 from $19,970,495 in 1998. Approximately $6.3 million of the increase is attributable to the now consolidated center operating expenses of HEARx West. Consolidated center operating expenses as a percent of revenue decreased in 1999 to 55% from 73% in 1998, which is generally attributable to the increase in sales. Increased advertising accounted for approximately $1,428,000, or 22% of the increase, offset by a decrease in rent expense of approximately $619,000 or 10% of the increase resulting from the closing of the 12 northeast centers in January 1999.

Consolidated general and administrative expenses increased 33% or $2,118,002 to $8,601,723 in 1999 from $6,483,721 in 1998, primarily as the result of the consolidation of HEARx West expenses of approximately $1.7 million. Consolidated general and administrative expenses as a percent of net revenue decreased to 18% in 1999 from 24% in 1998.

Depreciation and amortization expense increased $142,423, or 6%, to $2,420,891 in 1999 from $2,278,468 in 1998. An increase of $451,032 provided by HEARx West was offset by a reduction of $308,609 primarily attributable to the closing of twelve centers in the Northeast in January 1999.

LIQUIDITY AND CAPITAL RESOURCES

Working capital increased $1,412,019 to $2,350,834 as of December 29, 2000 from $938,815 as of December 31, 1999. On May 9, 2000 the Company completed a private placement of convertible preferred stock providing the Company with net proceeds of approximately $4,500,000. The Company believes that its current cash, investment securities and revenues from operations are sufficient to support the Company's operational needs in the year 2001.

Net cash used by operating activities decreased from $2,876,171 in 1999, to $798,375 in 2000. The decrease in cash being used by operating activities was primarily the result of the change in current assets, including accounts and notes receivable, from net cash used in 1999 of approximately $ 2.5 million to approximately $ 515,000 in 2000 offset against the change in accounts payable and accrued expenses from net cash provided in 1999 of approximately

$982,000 million to $10,000 in 2000. This is primarily the result of the Company improving its monitoring and collections process of accounts receivable.

Net cash provided by investing activities decreased from $5,418,632 in 1999, to cash used for investing activities of $1,610,009 in 2000. Proceeds from maturities of investments in excess of purchases were approximately $6.2 million in 1999, versus net purchases of approximately $93,000 in 2000.

Cash from financing activities increased from cash being used for financing activities of $2,335,385 in 1999 to cash being provided from financing activities of $3,801,610 in 2000. This increase was primarily the result of net proceeds of approximately $4,500,000, from a preferred stock offering during the second quarter of 2000. In addition, the Company acquired 129,900 shares of treasury stock for $413,061 in 2000 compared to 1,921,239 shares for $1,820,424 in 1999.

The Company has historically been successful in raising capital when needed and continues to have contact with investment bankers and lending institutions. The Company is currently evaluating new financing alternatives and may seek additional capital from the capital markets or otherwise, if available on favorable terms. There can be no assurance, however, that such capital will be available on favorable terms or at all when the Company's needs arise.

On May 9, 2000, the Company issued 7% Series I convertible preferred stock, which could not be converted until after August 6, 2000 and then at the fixed conversion price of $4.46 per share until January 2001. From January 2001 until May 2001, the holders may request redemption of the shares of preferred stock at 110% of the stated value plus accrued dividends. The Company may elect not to redeem the shares. If this occurs, the conversion price converts to the lesser of $4.46 or the market price (defined as the average of the 5 lowest closing prices for the 30 trading days preceding the conversion date) at the time of conversion.

RECENT ACCOUNTING PRONOUNCEMENTS

In June 1999, the Financial Accounting Standards Board (FASB) issued SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities. SFAS No. 133, amended by SFAS No. 137 requires companies to recognize all derivative contracts as either assets or liabilities in the balance sheet and to measure them at fair value. If certain conditions are met, a derivative may be specifically designated as a hedge, the objective of which is to match the timing of gain or loss recognition on the hedging derivative with the recognition of (i) the changes in the fair value of the hedged assets or liabilities that are attributable to the hedged risk or (ii) the earnings effect of the hedged forecasted transaction. For a derivative not designated as a hedging instrument, the gain and loss is recognized in income in the period of change. SFAS No. 133 is effective for all fiscal quarters of all fiscal years beginning after June 15, 2000.

Historically, the Company has not entered into derivative contracts either to hedge existing risks or for speculative purposes. Accordingly, the Company does not expect the adoption of the new standard as of January 1, 2001 to have material impact on the Company's financial position, results of operations, or cash flows.

In December 1999, the SEC staff release Staff Accounting Bulletin (SAB) No. 101, Revenue Recognition in Financial Statements, which provides interpretive guidance on the recognition presentation, and disclosure of revenue in financial statements. SAB 101 must be applied to financial statements no later than the quarter ended September 30, 2000. There was no material impact from the application of SAB 101 on the Company's financial position, results of operations, or cash flows.

In March 2000, the FASB issued Interpretation No. 44 (FIN 44), Accounting for Certain Transactions Involving Stock Compensation, and an interpretation of APB. 25. FIN 44 clarifies the application of APB 25 for (a) the definition of an employee for purposes of applying Opinion No. 25, (b) the criteria for determining whether a plan qualifies as a non-compensatory plan, (c) the accounting consequences of various modifications to the terms of a previously fixed stock option or award, and (d) the accounting for an exchange of stock compensation awards in business combination. FIN 44 became effective July 2, 2000, but certain conclusions cover specific events that occur after either December 15, 1998, or January 12, 2000. FIN 44 did not have a material impact on the Company's financial position, results of operations, or cash flow

Except for historical information provided in this discussion and analysis, the discussion includes forward looking statements, including the Company's goal of establishing a nationwide center network; plans for the TIME and Reader's Digest Large Print Edition promotionals; current working capital and revenues from operations being sufficient to support the Company's capital; the Company's belief concerning the effect on its financial condition or operations of changes in benefits announced by some insurance companies and the loss of any single contract. Such statements involve certain risks and uncertainties that could cause actual results to differ materially from those in the forward-looking statements. Potential risks and uncertainties include industry and market conditions, especially those affecting managed health care; unforeseen capital requirements; trends in market sales, and the success of the joint venture with The Permanente Federation and of the strategic marketing partnerships programs with TIME and Reader's Digest.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

The Company does not perceive in general that it is subject to risks in this area because it has not engaged in derivative transactions, or issue variable rate debt, and does not become exposed to foreign currencies in its business.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Financial Statement Schedule:

For the years ended December 29, 2000, December 31, 1999 and December 25, 1998

REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

Board of Directors
HEARx Ltd.
West Palm Beach, Florida

We have audited the accompanying consolidated balance sheets of HEARx Ltd. as of December 29, 2000 and December 31, 1999, and the related consolidated statements of operations, changes in stockholders' equity and cash flows for each of the three years in the period ended December 29, 2000. We have also audited the schedule listed in the accompanying index. These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of HEARx Ltd. at December 29, 2000 and December 31, 1999, and the results of its operations and its cash flows for each of the three years in the period ended December 29, 2000 in conformity with accounting principles generally accepted in the United States of America.

Also in our opinion, the schedule presents fairly, in all material respects, the information set forth therein.

West Palm Beach, Florida BDO Seidman, LLP
March 9, 2001

HEARx Ltd.
Consolidated Balance Sheets

ASSETS

	December 29, 2000	December 31, 1999
CURRENT ASSETS:		
Cash and cash equivalents	$ 4,250,413	$ 2,857,187
Investment securities (Note 2)	993,224	900,000
Accounts and notes receivable, less allowance for doubtful accounts of $ 212,657 and $535,609	5,734,497	5,874,286
Inventories	500,582	551,460
Prepaid expenses and other	860,272	531,169
Total current assets	12,338,988	10,714,102
PROPERTY AND EQUIPMENT - NET (Notes 3, 4 & 10)	7,595,991	8,492,708
DEPOSITS AND OTHER	1,937,144	2,170,300
	$ 21,872,123	$ 21,377,110

LIABILITIES AND STOCKHOLDERS' EQUITY

	December 29, 2000	December 31, 1999
CURRENT LIABILITIES:		
Accounts payable and accrued expenses	$ 7,377,495	$ 6,914,025
Accrued salaries and other compensation	1,071,208	1,562,510
Current maturities of long term debt (Note 3)	152,387	294,993
Dividends payable (Notes 5A, 5C and 5D)	1,387,066	1,003,759
Total current liabilities	9,988,156	9,775,287
LONG TERM DEBT, LESS CURRENT MATURITIES (Note 3)	175,887	322,332
COMMITMENTS AND CONTINGENCIES (Notes 4,6,8 & 11)	-	-
STOCKHOLDERS' EQUITY:		
Preferred stock: (Note 5) (Aggregate liquidation preference $ 11,902,067 and $9,318,757) $1 par, 2,000,000 shares authorized		
Series I Convertible 500 & 0 shares outstanding	500	-
Series H Junior Participating 0 shares outstanding	-	-

1998 Convertible 5,515 & 7,315 shares outstanding	5,515	7,315
1997 Convertible 0 & 1,000 shares outstanding	-	1,000
Total preferred stock	6,015	8,315
Common stock; $.10 par; 20,000,000 shares authorized; 12,364,139 & 11,547,337 shares issued (Notes 5 & 6)	1,236,414	1,154,734
Additional paid-in capital	92,695,792	87,307,886
Accumulated deficit	(79,746,700)	(75,083,251)
Unamortized deferred compensation	-	(37,813)
Treasury stock, at cost:518,660 & 388,760 common shares	(2,483,441)	(2,070,380)
Total stockholders' equity	11,708,080	11,279,491
	$ 21,872,123	$ 21,377,110

See accompanying notes to consolidated financial statements

HEARx Ltd.
Consolidated Statements of Operations

	Year Ended		
	December 29, 2000	December 31, 1999	December 25, 1998
NET REVENUE	$ 56,408,964	$ 47,686,868	$ 27,493,849
COSTS AND EXPENSES:			
Cost of products sold	18,966,110	14,611,284	8,193,058
Center operating expenses	29,328,114	26,376,830	19,970,495
General and administrative expenses	8,830,546	8,601,723	6,483,721
Depreciation and amortization	2,572,048	2,420,891	2,278,468
Interest expense	28,723	27,713	62,492
Restructure charge (Note 10)	-	-	2,233,857
Total costs and expenses	59,725,541	52,038,441	39,222,091
LOSS BEFORE MINORITY INTEREST AND EQUITY IN LOSS OF JOINT VENTURE	(3,316,577)	(4,351,573)	(11,728,242)
MINORITY INTEREST	-	347,677	-

EQUITY IN LOSS OF JOINT VENTURE	-	-	(615,420)
NET LOSS	(3,316,577)	(4,003,896)	(12,343,662)
DIVIDENDS ON PREFERRED STOCK:			
Deemed dividends (Note 5A)	(571,241)	-	-
Dividends	(775,631)	(821,387)	(587,893)
Total dividends on preferred stock	(1,346,872)	(821,387)	(587,893)
NET LOSS APPLICABLE TO COMMON STOCKHOLDERS	$ (4,663,449)	$ (4,825,283)	$ (12,931,555)
NET LOSS PER COMMON SHARE - BASIC AND DILUTED (NOTE 1)	$ (.39)	$ (.45)	$ (1.28)
WEIGHTED AVERAGE NUMBER OF SHARES OF COMMON STOCK OUTSTANDING (NOTE 1)	11,834,388	10,775,006	10,126,979

See accompanying notes to consolidated financial statements

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HEARx Ltd.
Consolidated Statements of Changes in Stockholders' Equity

	Year Ended December 29,2000		Year Ended December 31, 1999	
	Shares	Amount	Shares	Amount
PREFERRED STOCK:				
Balance, beginning of year	8,315	$ 8,315	12,709	$ 12,709
Issuance of preferred stock	500	500	--	--
Conversion of preferred stock	(2,800)	(2,800)	(4,394)	(4,394)
Balance, end of year	6,015	$ 6,015	8,315	$ 8,315
COMMON STOCK:				
Balance, beginning of year	11,547,337	$ 1,154,734	104,023,643	$ 10,402,364
Exercise of warrants	--	--	--	--
Conversion of preferred stock	817,202	81,720	5,414,400	541,440
Exercise of employee stock options	1,600	160	13,600	1,360
Exercise of stock options by				

consultants	(2,000)	(200)	--	--
Exercise of stock options by Board of Directors	--	--	--	--
Reverse stock split	--	--	(97,904,306)	(9,790,430)
Balance, end of year	12,364,139	$ 1,236,414	11,547,337	$ 1,154,734
TREASURY STOCK:				
Balance, beginning of year	(388,760)	$(2,070,380)	(405,311)	$ (249,956)
Purchase of treasury stock	(129,900)	(413,061)	(1,921,239)	(1,820,424)
Reverse Stock Split	--	--	1,937,790	
Balance, end of year	(518,660)	$(2,483,441)	(388,760)	$ (2,070,380)
ADDITIONAL PAID-IN CAPITAL:				
Balance, beginning of year		$87,307,886		$ 77,531,270
Issuance of preferred stock		4,999,500		--
Cost of issuing preferred stock		(479,617)		
Conversion of preferred stock		313,402		31,852
Exercise of warrants		--		--
Exercise of employee stock options		3,180		1,500
Exercise of stock options by consultants		(19,800)		--
Exercise of stock options by Board of Directors		--		--
Deemed dividend		571,241		--
Reverse stock split		--		9,743,264
Vesting of restricted stock		--		--
Balance, end of year		$92,695,792		$ 87,307,886

See accompanying notes to consolidated financial statements

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HEARX Ltd.
Consolidated Statements of Chnages in Stockholders' Equity

	Year Ended December 29,2000	Year Ended December 31, 1999	D

	Amount	Amount
ACCUMULATED DEFICIT:		
Balance, beginning of year	$(75,083,251)	$(70,257,968)
Net loss for the year	(3,316,577)	(4,003,896)
Deemed dividends on preferred stock	(571,241)	-
Preferred stock dividends	(775,631)	(821,387)
Balance, end of year	$(79,746,700)	$(75,083,251)
UNAMORTIZED DEFERRED COMPENSATION:		
Balance, beginning of year	$ (37,813)	$ (75,625)
Issuance of restricted stock to officer	-	-
Amortization	37,813	37,812
Balance, end of year	$ -	$ (37,813)
ACCUMULATED OTHER COMPREHENSIVE INCOME:		
Balance, beginning of year	$ -	$ 58,263
Unrealized gains on securities net of reclassification adjustment (see disclosure)	-	(58,263)
Balance, end of year	-	$ -
COMPREHENSIVE INCOME (LOSS):		
Net loss for the year	$(3,316,577)	$ (4,003,896)
Other comprehensive income (loss)	-	(58,263)
Comprehensive income(loss)	$(3,316,577)	$ (4,062,159)
Disclosure of reclassification amount:		
Unrealized holding gains (losses) arising during period	$ -	$ (84,022)
Less: reclassification adjustment for gains (losses) included in net loss	-	25,759
Net unrealized gains (losses) on securities	$ -	$ (58,263)

See notes to accompanying consolidated finanical statements

HEARx Ltd.
Consolidated Statements of Cash Flows

	Year Ended		
	December 29, 2000	December 31, 1999	December 1998
Cash flows from operating activities:			
Net loss	$(3,316,577)	$ (4,003,896)	$ (12,343,66
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization	2,572,048	2,420,891	2,278,46
Write down of property and equipment	-	-	783,11
Provision for doubtful accts	377,500	568,135	553,46
Loss on disposition of equipment	72,005	40,325	60,23
Minority Interest	-	(347,677)	
(Increase) decrease in:			
Accounts and notes receivable	(237,711)	(2,395,710)	(1,384,66
Inventories	50,878	(21,265)	(6,07
Prepaid expenses and other	(326,485)	(119,092)	(2,108,86
Increase (decrease) in:			
Accounts payable	463,470	1,372,605	991,6
Accrued expenses	(453,503)	(390,486)	2,056,4
Net cash used in operating activities	(798,375)	(2,876,171)	(9,119,9
Cash flow from investing activities:			
Purchase of property and equipment	(1,519,764)	(1,450,107)	(1,140,9
Proceeds from sale of equipment	2,979	-	48,4
Purchase of investments	10,375,928)	(2,750,000)	(24,287,4
Proceeds from maturities of investments	10,282,704	8,962,516	27,436,6
Net cash from consolidating HEARx West	-	656,223	
Net cash (used in) provided by investing Activities	(1,610,009)	5,418,632	2,056,7
Cash flows from financing activities:			
Proceeds from issuance of:			
Long-term debt	-	35,250	
Principal payments:			
Long-term debt	(289,051)	(505,905)	(465,61
Acquisition of treasury stock	(413,061)	(1,820,424)	(249,95
Proceeds from issuance of capital stock, net of offering costs	4,503,722	(44,306)	6,784,01
Net cash provided(used in) by financing activities	3,801,610	(2,335,385)	6,068,45
Net increase(decrease) in cash and cash equivalents	1,393,226	207,076	(994,72
Cash and cash equivalents at beginning of year	2,857,187	2,650,111	3,644,83

Cash and cash equivalents at end of year	$ 4,250,413	$ 2,857,187	$ 2,650,11

See accompanying notes to consolidated financial statements

HEARX Ltd.
Consolidated Statements of Cash Flows

	Year Ended		
	December 29, 2000	December 31, 1999	December 25 1998
Supplemental disclosure of cash flow information:			
Cash paid for interest	$ 32,251	$ 7,419	$ 8,8
Supplemental schedule of non-cash investing and financing activities			
Deemed dividends	$ 571,241	$ -	$ -
Preferred stock dividend paid upon conversion in kind by issuance of additional common stock	392,323	568,898	168,7
Issuance of note payable and assumption of accounts payable in exchange for customer list and equipment	-	482,496	-
Issuance of Common Stock to employees	3,340	2,860	54,1

See accompanying notes to consolidated financial statements

HEARx Ltd
Notes To Consolidated Financial Statements

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The Company

HEARx Ltd. ("HEARx" or "the Company"), a Delaware corporation, was organized for the purpose of creating a nationwide chain of retail centers ("HEARx Centers") to serve the needs of the hearing impaired. At the end of 2000, the Company operated a total of 80 centers. Those included 33 in Florida, 13 in New York, 15 in New Jersey and the 19 HEARx West centers in California.

Segments

The Company's operations are organized by centers into three geographic regions, the Northeast, Florida and California. These regions comprise one operating segment. Net revenues by region for the Northeast, Florida and California were approximately $14.2 million, $24.0 million, and $18.0 million in 2000; $10.1 million, $25.0 million and $12.4 million in 1999; and $7.8 million, $19.0 million, and $19,000 in 1998. Operating profits at the center level for the year ended December 29, 2000, were approximately $861,000, $4,529,000 and $2,430,000 for the Northeast, Florida and California, respectively compared to an operating loss of approximately $680,000 for the Northeast, and operating profit of approximately $5,470,000 and $1,970,000, for Florida and California, respectively, for 1999 and an operating loss of approximately $3,888,000 and $608,000 for the Northeast and California, respectively, and operating profit of approximately $2,615,000 in Florida, for 1998. Operating profits at the center level are computed before corporate general and administrative expenses, depreciation/amortization and preferred dividends. Center operations' depreciation amounted to $1,863,000, $1,793,000 and $1,632,000 in 2000, 1999 and 1998, respectively. Center operations' capital expenditures amounted to $952,000, $1,450,000 and $1,141,000 in 2000, 1999 and 1998, respectively. Aggregate identifiable assets of center operations at December 29, 2000 and December 31, 1999 were $7,159,000 and $7,961,000, respectively.

Consolidation and change in reporting entity

On August 10, 1998, HEARx formed a joint venture, HEARx West LLC, with the Permanente Federation LLC to create and operate a network of retail hearing care centers ("HEARx West Centers"). The joint venture agreement provides for a 50/50 ownership by HEARx and the Permanente Federation, with centers bearing the HEARx name. The agreement provides for net income and losses, tax credits and tax preference items to be allocated according to the members' percentage interests.

Prior to March 1999, HEARx Ltd. accounted for its investment in HEARx West using the equity method because HEARx did not control HEARx West due to certain provisions in the joint venture agreement. In March 1999, as a result of amendments to the agreement, HEARx obtained control of HEARx West. Accordingly, at December 29, 2000 and December 31, 1999, HEARx has included the financial position and results of operations of HEARx West in the accompanying consolidated financial statements.

Fiscal year

The Company's fiscal year ends on the last Saturday in December and customarily consists of four 13-week quarters for a total of 52 weeks. Every sixth year includes 53 weeks.

Investment securities

Marketable securities are classified available for sale and are carried at estimated market value. Unrealized holding gains and losses are reported as a net amount in a separate component of stockholders' equity until realized. Gains and losses realized from the sales are computed by the specific identification method.

Inventories

Inventories, which consist of hearing aids, batteries, special hearing devices and related items, are priced at the lower of cost (first-in, first-out) or market.

Property and equipment

Property and equipment is stated at cost. Depreciation is provided on the straight-line method over the estimated useful lives of the depreciable assets. Leasehold improvements are amortized over the shorter of the term of the lease or the useful life of the asset.

Intangible assets

Intangible assets, included in other assets, primarily represent customer lists acquired from acquisitions of hearing businesses. These customer lists are being amortized on a straight-line basis over periods ranging from nine to fifteen years. Intangible assets also include the excess purchase price of acquisitions over the fair value of assets acquired. Such excess costs are being amortized over fifteen years. Accumulated amortization at December 29, 2000 and December 31, 1999 was $464,659 and $350,608, respectively.

Pre-opening costs

The costs associated with the opening of new centers are expensed as incurred.

Long-lived assets - impairments and disposals

The Company reviews the carrying values of its long-lived and identifiable intangible assets for possible impairment whenever events or changes in circumstances indicate that the carrying amounts of the assets may not be recoverable. At December 29, 2000, no long-lived assets were held for disposal.

Advertising Costs

Costs for newspaper, television, and other media advertising are expensed as incurred and were $7,757,000, $5,470,000 and $4,105,000 in 2000, 1999, and 1998, respectively.

Sales return policy

Patients purchasing hearing aids are given a specific return period, usually 30 days, if dissatisfied with the product. The Company provides an allowance in accrued expenses for returns. The return period can be extended to 60 days if the customer attends the Company's H.E.L.P. program.

Deferred compensation

The value in excess of the selling price of shares of common stock issued to officers is amortized over the vesting period of such shares.

Warranties

Hearing aids sold by the Company are covered by manufacturers' warranties.

Capitation revenue

The Company has capitation contracts with certain health care organizations under which the Company is paid an amount, per enrollee of the health maintenance organization, to provide to the enrollee a once every three years discount on certain hearing products and services. The amount paid to the Company by the healthcare organization is calculated on a per-capita basis and is referred to as capitation revenue. Revenue under capitation contracts is recorded based on actual utilization by the member populations of the healthcare organizations with whom the Company has contracted to provide hearing care services.

Income taxes

Deferred taxes are provided for temporary differences arising from the differences between financial statement and income tax bases of assets and liabilities. A valuation allowance is provided for the amount of deferred tax assets which are not considered more likely than not to be realized.

Net loss per common share

Net loss per common share is calculated in accordance with Statement of Financial Accounting Standards ("SFAS") No. 128 "Earnings Per Share" which requires companies to present basic and diluted earnings per share. Net loss per share - Basic is based on the weighted average number of common shares outstanding during the year. Net loss per common share - Diluted is based on the weighted average number of common shares and dilutive potential common shares outstanding during the year. Convertible preferred stock, stock options and stock warrants are excluded from the computations of net loss per share because the effect of their inclusion would be anti-dilutive.

Excluded from the computation of net loss per common share - diluted at December 29, 2000, December 31, 1999 and December 25, 1998 were convertible preferred stock, outstanding options and warrants to purchase 3,457,296, 2,693,885 and 1,773,928 shares, respectively, of the Company's Common Stock at exercise prices less than average market price because to not do so would be anti-dilutive. In addition, outstanding options and warrants to purchase 1,568,560, 889,941 and 394,268 shares of common stock were excluded because the options' and warrants' exercise prices were greater than the average market price of the common shares.

Statements of Cash Flows

For the purposes of the Statements of Cash Flows, temporary cash investments which have a maturity of ninety days or less are considered cash equivalents.

Reclassifications

Certain amounts in the 1999 and 1998 financial statements have been reclassified in order to conform to the 2000 presentation.

Estimates

The preparation of the financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Stock-based compensation

The Company has elected to follow Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees' (APB 25) and related interpretations in accounting for its employee stock options. Under APB 25, because the exercise price of employee stock options equals the market price of the underlying stock on the date of grant, no compensation expense is recorded. The Company has adopted the disclosure only provisions of SFAS No. 123, ("SFAS 123") Accounting for Stock-Based Compensation.

2. INVESTMENT SECURITIES

Investment securities available for sale consist of the following:

	Amortized Cost	Gross Unrealized Gains/(Losses)	Estimated Market Value
December 29, 2000			

Asset-Backed Securities	$750,000	--	$750,000
Certificates of Deposit	243,224	--	243,224
Total	$993,224	$ --	$993,224
December 31, 1999			
Asset-Backed Securities	$750,000	$ --	$750,000
Certificate of Deposit	150,000	--	150,000
Total	$900,000	$ --	$900,000

At December 29, 2000, $750,000 and $243,225 of investment securities have contractual maturities of twenty and one years, respectively.

3. DEBT

Long term debt consists of the following:

	December 29, 2000	December 31, 1999
Note payable to supplier, collateralized by equipment, due January 13, 2000, see (a) below	$ --	$ 140,000
Note payable collateralized by customer list, see (b)& (c) below	291,144	417,316
Other notes payable	37,130	60,009
	328,274	617,325
Less current maturities	(152,387)	(294,993)
	$ 175,887	$ 322,332

The approximate aggregate maturities on long term debt obligations in years subsequent to 2000 are as follows: 2001 - $152,000; 2002 - $95,000; and 2003 - $81,000.

(a) On March 5, 1996, the Company completed a $2.5 million trade agreement with a vendor pursuant to which the vendor provides financing for the purchase of diagnostic equipment to be utilized by the Company's distribution network. The financing is collateralized by the equipment financed. A percentage of all hearing aid purchases by the Company from this vendor is applied to repayment of financed amounts under the financing agreement. This note was repaid in January 2000.

(b) In January 1996, the Company acquired the customer list and selected assets of Suffolk County Hearing Aid Center, Inc. in New York for $150,000 in cash, 150,000 shares of Common Stock, and a five year note in the amount of $250,000 including interest. The note payable includes interest at 5.5% and is payable in five annual installments of $50,000 including interest beginning January 22, 1997.

(c) During July 1999, the Company issued a $325,000 promissory note payable bearing 8.75% interest to an individual in connection with a purchase of an audiological practice in California, (See Note 8). The note is payable in four annual installments of $81,250 plus accrued interest, beginning July 1, 2000 and is collateralized by the equipment and customer list purchased.

4. PROPERTY AND EQUIPMENT AND LEASES

Property and equipment consists of the following:

	Range of Useful Lives	December 29, 2000	December 31, 1999
Equipment, furniture and fixtures	5 -10 years	$ 7,922,131	$ 7,472,695
Leasehold Improvements	5 -10 years	6,554,421	6,123,687
Computer systems	3 years	3,363,613	3,055,847
Leasehold improvements in progress	N/A	147,050	37,485
		17,987,215	16,689,714
Less accumulated depreciation and amortization		10,391,224	8,197,006
		$ 7,595,991	$ 8,492,708

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Approximate future minimum rental commitments under operating leases are as follows: $4,301,000 in 2001; $4,062,000 in 2002; $3,626,000 in 2003; $2,858,000 in 2004; $2,527,000 in 2005 and $1,237,000 thereafter. These leases are primarily for hearing centers and are located in retail shopping areas.

Equipment and building rent expense for the years ended December 29, 2000, December 31, 1999 and December 25, 1998 was $3,181,000, $2,956,000 and $2,892,000, respectively.

5. STOCKHOLDERS' EQUITY

A. SERIES I CONVERTIBLE PREFERRED STOCK

On May 9, 2000, the Company completed a private placement of 500 shares of the Company's 7% Series I Convertible Preferred Stock, par value $1.00 per share (the "Series I Preferred Stock") and warrants to acquire 203,390 shares of the Company's common stock, par value $.10 per share (the "Common Stock") (the "Warrants") for an aggregate purchase price of $5.0 million.

The Series I Preferred Stock is convertible into Common Stock after August 6, 2000. Upon conversion, holders will be entitled to receive a number of shares of Common Stock determined by dividing the sum of the stated value of the Series I Preferred Stock ($10,000 per share), plus accrued and unpaid dividends (unless the Company elects to pay dividends in cash) by $4.46 (subject to adjustments upon occurrence of certain dilutive events). The dividends payable upon conversion will be equal to 7% of the stated value of the Series I Preferred Stock per annum in cash or by accretion to the Stated Value, at the Company's discretion subject to limited exceptions. The Series I Preferred Stock may not be converted until after August 6, 2000 and then at the fixed conversion price of $4.46 per share until January 2001. From January 2001 until May 2001, the holders may request redemption of the shares of preferred stock at 110% of the stated value plus accrued dividends. If the Company elects not to redeem the shares, the conversion price converts to the lesser of $4.46 or the market price (defined as the average of the 5 lowest closing prices for the 30 trading days preceding the conversion date) at the time of conversion. The Series I Preferred Stock may be converted by holders in accordance with these terms any time prior to May 9, 2003, and will automatically convert on such date. In the event of liquidation, dissolution or winding up of the Company prior to the conversion of the Series I Preferred Stock, holders of the Series I Preferred Stock will be entitled to receive an amount equal to the stated value per share before any distribution shall be made to the holders of any junior securities but after any distribution made to holders of senior securities.

The Warrants are exercisable for shares of Common Stock of the Company. Upon exercise, holders will be entitled to receive shares of common Stock for an exercise price of $4.46 per share. The Warrants will expire on May 9, 2005.

During the year ended December 29, 2000, the Company recorded a deemed dividend of approximately $571,000 for the intrinsic value of the beneficial conversion option under the terms of the Series I Convertible Preferred Stock. The deemed dividend includes an allocation of the proceeds to the relative fair value of the Warrants of approximately $285,500, and the intrinsic value of the beneficial conversion of approximately $285,500.

In connection with this transaction, the Company also entered into a Registration Rights Agreement with the purchaser under which the Company was required to file a registration statement on Form S-3 by June 8, 2000, covering the resale of the shares of Common Stock underlying all of the Series I Preferred Stock and Warrants. The registration statement was declared effective by the Securities and Exchange Commission on June 19, 2000.

The net proceeds to the Company after payment of finders fees, placement fees. legal and accounting expenses was approximately $4,500,000. In connection with the placement of the Series I Preferred Stock, the Company also issued finders warrants to purchase an aggregate of 131,695 shares of Common Stock at an exercise price equal to $4.46. All of the shares

underlying the finder warrants were included in the registration statement on Form S-3 filed by the Company.

B. REVERSE STOCK SPLIT

On June 30, 1999 the Company effectuated a one for ten reverse common stock split. The reverse stock split and a reduction in the authorized shares of common stock to twenty million was approved at the June 7, 1999 Annual Meeting of Stockholders. Each stockholder of ten shares of common stock on June 30, 1999 was entitled to one share of common stock in connection with the reverse split.

A cash payment was paid in lieu of fractional shares issued. Accordingly, except for the presentation in the accompanying consolidated balance sheets and statements of changes in stockholders' equity, the Company has restated all share and per share data for all periods presented to reflect the change in capital structure.

C. 1998 CONVERTIBLE PREFERRED STOCK

On August 27, 1998, the Company completed a private placement of 7,500 units of $1 par, 1998 Convertible Preferred Stock and warrants. Net proceeds to the Company after the payment of placement fees, legal and accounting expenses was $6,975,000. The additional capital was primarily raised to fund construction and start-up costs of the HEARx West centers.

The 1998 Convertible Preferred Stock ranks prior to all of the Company's Common Stock, prior to any class or series of capital stock of the Company thereafter created specifically ranking by its terms junior to 1998 Convertible Preferred, junior to with the Company's 1997 Convertible Preferred Stock, and after any class or series of capital stock of the Company thereafter created and specifically ranking by its terms senior to the 1998 Convertible Preferred. The 1998 Preferred Stock is convertible into Common Stock, par value $.10 per share, of the Company. Upon the conversion, holders will be entitled to receive a number of shares of Common Stock determined by dividing the sum of the stated value of the 1998 Preferred Stock ($1,000 per share), plus a premium (unless the Company elects to pay that premium in cash), by a conversion price equal to the lesser of the average closing bid prices for the Common Stock of five of twenty days prior to conversion, and $18.00 (the closing bid price at the date of issuance, subject to adjustment upon occurrence of certain dilutive events). The premium payable upon conversion will be equal to 8% of the stated value of 1998 Preferred Stock from the date of issuance until one year following such date, and shall increase by 0.5% each year, commencing on the date which is one year following the date of issuance. The 1998 Preferred Stock may not be converted for the 180-day period after the closing. The 1998 Preferred Stock may be converted by holders in accordance with these terms at any time prior to August 27, 2003, and automatically converts on such date. In the event of liquidation, dissolution or winding up of the Company prior to conversion of the 1998 Preferred Stock, holders of 1998 Preferred Stock will be entitled to share ratably in all assets available for distribution prior to distributions to holders of Common Stock. In addition, no distributions may be made to holders of Common Stock until holders of 1998 Preferred Stock shall have received a liquidation preference equal to the sum of the stated value of the 1998 Preferred Stock ($1,000 per share) plus an amount equal to ten percent (10%) per annum of such stated value for the period from the date of issuance until the date of final distribution. During 2000 and 1999, 1,800 and 185 shares of the 1998 Convertible Preferred Stock plus accrued dividends of $216,926 and $16,156 were converted into 94,109 and 44,712 shares of the Company's Common Stock.

For each unit of 1998 Convertible Preferred Stock purchased, each investor received 7.5 warrants to acquire shares of Common Stock of the Company. Upon exercise, holders will be entitled to receive shares of Common Stock for an exercise price of $18.00 per share. The warrants will expire on August 27, 2003. In connection with this transaction, the Company issued 56,250 warrants with an exercise price of $18.00 to purchase shares of the Company's Common Stock. These warrants were issued to certain individuals as finder's fees for the placement of preferred shares with investors. All related warrants remain outstanding as of December 29, 2000.

D. 1997 CONVERTIBLE PREFERRED STOCK

The 1997 Convertible Preferred Stock ranks prior to all of the Company's Common Stock, prior to any class or series of capital stock of the Company thereafter created specifically ranking by its terms junior to 1997 Convertible Preferred, pari passu with the Company's 1996 Series B-1 Convertible Preferred Stock, 1996 Series B-2 Convertible Preferred Stock and after any class or series of capital stock of the Company thereafter created and specifically ranking by its terms senior to the 1997 Convertible Preferred. The 1997 Convertible Preferred Stock bears dividends of 6%, payment in kind or cash upon conversion at the option of the Company. Upon conversion of the Preferred Stock, holders will be entitled to receive a number of shares of Common Stock determined by dividing the stated value of the Preferred Stock ($1,000 per share), plus a premium in the amount of 6% per annum of the stated value from the date of issuance (unless the Company chooses to redeem the shares otherwise issuable in respect of that premium) by a conversion price equal to the lesser of (i) $50.00, or (ii) 85% of the average of the closing bid prices for shares of Common Stock for the ten day trading period immediately prior to conversion. The 1997 Convertible Preferred Stock may be converted by holders beginning August 15, 1997 and at any time prior to March 17, 2000 and must be converted on that date. During 2000, 1999 and 1998, 1,000, 4,209, and 1,906 shares of the 1997 Convertible Preferred Stock plus accrued dividends of $175,397, $552,743, and $168,787 were converted into 299,214, 1,098,906, and 326,538 shares of the Company's Common Stock, respectively. No shares of the 1997 Convertible Preferred Stock were outstanding as of December 29, 2000.

In connection with the 1997 Convertible Preferred Stock, the Company issued 85,000 warrants with an exercise price of $50.00 and 75,000 warrants with an exercise price of $20.00 to purchase shares of the Company's Common Stock. These warrants were issued to certain individuals as finder's fees for the placement of the preferred shares with investors. All related warrants remain outstanding as of December 29, 2000.

E. 1996 SERIES A, B-1 AND B-2 CONVERTIBLE PREFERRED STOCK

As of December 26, 1997, all of the shares of the 1996 Series A, B-1, and B-2 Preferred Stock had been converted into shares of Common Stock. Upon conversion of the Series B-1 Preferred Stock, holders were entitled to and were issued 375,000 warrants to acquire shares of Common Stock at $64.70 per share. On August 27, 1998, the Company cancelled 426,413 warrants in exchange for 65,975 new warrants with an exercise price of $20.00. The new warrants are exercisable any time prior to August 24, 2003.

F. 1996 SENIOR PREFERRED STOCK

Holders of the 1996 Senior Preferred Stock received warrants to purchase 1,107,048 shares of common stock at an exercise price of $5.50 per share. Additionally 228,327 warrants, to acquire shares of Common Stock at $ 6.30 per share, were issued to an investment banker as a placement fee. The Company redeemed the 1996 Senior Preferred Stock during May 1996. All but 9,226 of the related warrants had been exercised as of December 29, 2000.

G. SHAREHOLDER RIGHTS PLAN

On December 14, 1999, the Board of Directors approved the adoption of a Shareholder Rights Plan, in which a dividend of one preferred share purchase right (a "Right") for each outstanding share of Common Stock was declared, and payable to the stockholders of record on December 31, 1999. The Rights will be exercisable only if a person or group acquires 15% or more of the Company's Common Stock or announces a tender offer which would result in ownership of 15% or more of the Common Stock. The Rights entitle the holder to purchase one

one-hundredth of a share of Series H Junior Participating Preferred Stock at an exercise price of $28.00 and will expire on December 31, 2009.

Following the acquisition of 15% or more of the Company's Common Stock by a person or group without the prior approval of the Board of Directors, the holders of the Rights (other than the acquiring person) will be entitled to purchase shares of Common Stock (or Common Stock equivalents) at one-half the then current market price of the Common Stock, or at the election of the Board of Directors, to exchange each Right for one share of the Company's Common Stock (or Common Stock equivalent). In the event of a merger or other acquisition of the Company without the prior approval of the Board of Directors, each Right will entitle the holder (other than the acquiring person), to buy shares of common stock of the acquiring entity at one-half of the market price of those shares. The Company will be able to redeem the Rights at $0.01 per Right at any time until a person or group acquires 15% or more of the Company's Common Stock.

The Series H Junior Participating Preferred Stock is subject to the rights of the holders of any shares of any series of preferred stock of the Company ranking prior and superior to the Series H Junior participating Preferred Stock with respect to dividends. The holders of shares of Series H Junior Participating Preferred; in preference to the holders of shares of Common Stock, and any other junior stock, shall be entitled to receive dividends, when, as and if declared by the Board of Directors out of funds legally available therefore.

H. WARRANTS

No warrants were exercised in 2000.

On May 9, 2000, the Company issued warrants with an exercise price of $4.46 to purchase 335,085 shares of the Company's Common Stock. These warrants were issued in connection with the private placement of 500 units of 7% Series I Convertible Preferred Stock The warrants are exercisable any time prior to May 9, 2005.

The aggregate number of common shares reserved for issuance upon the exercise of warrants is 760,998 as of December 29, 2000. The expiration date and exercise prices of the outstanding warrants are as follows:

OUTSTANDING WARRANTS	EXPIRATION DATE	EXERCISE PRICE
59,500	2002	$50.00
75,000	2001	20.00
57,712	2003	12.50
30,000	2001	6.30
9,225	2001	5.50
65,975	2003	20.00
112,501	2003	18.00
16,000	Various	6.30-40.00
335,085	2005	4.46
760,998		

6. STOCK PLANS

The Company has the following stock plans:

A. EMPLOYEE STOCK OPTION PLANS

In 1987, the Company established the 1987 Stock Options Plan. It is administered by the Company's Board of Directors. A maximum of 250,000 shares of Common Stock were authorized for issuance under this plan. All employees of the Company, other than the principal stockholder, were eligible to receive options under this plan at the sole discretion of the Board of

Directors. Both incentive and non-incentive stock options could be granted. This plan expired June 2, 1997 and no further option grants can be made under this plan. The expiration of the plan did not affect the outstanding options which shall remain in full force as if the plan had not expired.

In 1995, the Company established the 1995 Flexible Stock Plan. It is also administered by the Company's Board of Directors. An original maximum of 250,000 shares of the Company's Common Stock were authorized for issuance under this plan. On June 6, 2000 the shareholders approved an increase of 500,000 shares of the Company's stock available under this plan. The plan authorizes an annual increase in authorized shares equal to 10% of the number of shares authorized as of the prior year. Currently an aggregate of 424,647 shares may be issued under the plan. All employees of the Company are eligible to receive stock options under this plan at the sole discretion of the Board of Directors. Incentive stock options, non-qualified stock options, stock appreciation rights, restricted shares, performance shares, and other stock-based awards may be awarded under this plan.

On December 14, 1999 the Board of Directors approved the issuance of non-qualified stock options to purchase 268,246 shares of the Company's Common Stock for $3.88 per share to certain officers of the Company. These grants are independent of the Company's 1987 and 1995 stock option plans and are to be issued from shares of treasury stock.

As of December 29, 2000, 346 employees of the Company held options under the Stock Option Plans permitting them to purchase 873,957 shares of Common Stock at prices ranging from $2.00 to $18.75 per share. Options are exercisable for periods ranging from four to nine years commencing one year following the date of grant and are exercisable in cumulative annual installments of 25 percent per year.

The following table summarizes the transactions of the Company's employee stock option plans:

	Year Ended		
	December 29, 2000	December 31, 1999	December 25, 19

	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares	Weigh Avera Exerc Pric
Outstanding at beginning of year	764,194	$5.78	464,718	$7.19	466,178	$15.
Granted	152,360	$4.12	342,256	$4.17	528,080	$10.
Exercised	1,600	$2.09	1,360	$2.10	10,498	$5.2
Forfeited and cancelled	40,997	$7.42	41,420	$8.45	519,042	$18.
Outstanding at end of year	873,957	$5.42	764,194	$5.78	464,718	$6.7
Exercisable at end of year	452,214		345,921		272,230	
Weighted average fair market of options granted during year	$ 3.43		$ 2.96		$ 7.30	

The following table summarizes information about fixed employee stock options outstanding at December 29, 2000:

Range of Exercise Price	Options Outstanding	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Options Exercisable At December 29, 2000	Weighted Average Exercise Price
$2.00	48,515	3.4	$2.00	48,515	$2.00
$2.10 - $5.40	458,871	6.3	$4.01	110,435	$4.31
$5.41 - $8.75	347,631	5.9	$7.21	278,744	$7.43
$8.75 - $30.00	18,940	6.3	$15.64	14,520	$15.56
	873,957			452,214	

The stock options are exercisable in the following years:

2001	591,178
2002	128,468
2003	117,866
2004	36,445
	873,957

SFAS 123, Accounting for Stock-Based Compensation, requires the Company to provide pro forma information regarding net loss and loss per share as if compensation cost for the Company's employee stock option plans had been determined in accordance with the fair value based method prescribed in SFAS 123. The Company estimates the fair value of each option at the grant date by using the Black-Scholes option pricing model with the following weighted-average assumptions used for grants in 2000, 1999, and 1998, respectively, no dividends, expected volatility of 89%, 89% and 59%; risk-free interest rates of 5.12%, 6.65% and 5.74% and expected lives ranging from 5 to 10 years.

Under accounting provisions of SFAS 123, the Company's net loss and loss per share would have been increased to pro forma amounts indicated below:

	2000	1999	1998
Net Loss applicable to Common Stockholders			
As reported	$ (4,663,450)	$ (4,825,283)	$ (12,931,555)
Pro forma	$ (5,591,000)	$ (5,896,000)	$ (14,718,000)
Loss per share - basic and diluted			
As reported	$ (0.39)	$ (0.45)	$ (1.28)
Pro forma	$ (0.47)	$ (0.55)	$ (1.45)

B. NON-EMPLOYEE DIRECTOR PLAN

In April 1993, the stockholders of the Company approved the adoption of the HEARx Ltd. Non-qualified Stock Option Plan for Non-Employee Directors ("Directors Plan"). The purpose of the Directors Plan is to increase the proprietary interest of non-employee directors and promote long-term stockholder value by granting stock options. Grants cannot exceed 50,000 shares of Common Stock in the aggregate and may be granted until the Annual Meeting of Stockholders in 2003. Under the plan, non-employee directors are granted 1,500 options each year. The option price is the fair market value of the Company's shares at the date of grant.

As of December 29, 2000, three directors hold options as follows: 3,000 shares at $ 3.40, 4,500 at $4.00, 4,500 shares at $5.00, 4,500 shares at $ 6.875, 16,500 at $7.50, and 4,500 shares at prices ranging from $12.50 to $58.75 per share.

C. STOCK BONUS PLAN

The Board of Directors adopted a Stock Bonus Plan ("Bonus Plan"). The number of shares of Common Stock which can be issued under the Bonus Plan cannot exceed 50,000. It is administered by the Board of Directors. The purpose of the Bonus Plan is to provide an incentive to senior management to achieve the Company's strategic objectives. At present there are nine senior management personnel eligible to participate. No shares were issued in 2000, 1999 or 1998..

7. MAJOR CUSTOMERS

During 1999, the Company did not have sales totaling 10% or more of the total net sales to a single customer. In 2000 and 1998, the Company had sales totaling

$ 5.7 million and $3.3 million, or 10.1% and 12.7% of net sales to two different single customers.

8. RELATED PARTY TRANSACTIONS

On January 6, 1999 HEARx West entered into a capitation contract with an affiliate (the "Kaiser Plan") of its minority owner, the Permanente Federation LLC (the "Plan"). Under the terms of the

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$.001 par value, 120,000,000 shares authorized,

33,914,666 and 33,304,681 shares outstanding, respectively

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Additional paid-in capital

250,228

247,137

Retained earnings

55,937

48,517

Treasury stock, at cost, 2,254,953 shares in treasury

(28,182

)

(28,182

)

Accumulated other comprehensive loss

(1,521

)

(1,789

)

Total stockholders’ equity		276,496		265,716
Total liabilities and stockholders’ equity	$	738,338	$	708,905

See accompanying notes to the consolidated financial statements.

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HEALTHWAYS, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(In thousands, except earnings per share data)
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Revenues	$ 166,559	$ 176,206	$ 501,990	$ 508,770
Cost of services (exclusive of depreciation and amortization of $9,158, $8,973, $26,689, and $26,967, respectively, included below)	126,782	129,588	396,321	377,513
Selling, general and administrative expenses	14,727	14,185	43,455	49,724
Depreciation and amortization	13,259	12,467	38,233	37,343
Operating income	11,791	19,966	23,981	44,190
Interest expense	3,249	3,221	10,822	9,809
Income before income taxes	8,542	16,745	13,159	34,381
Income tax expense	3,514	7,281	5,739	15,004
Net income	$ 5,028	$ 9,464	$ 7,420	$ 19,377
Earnings per share:				
Basic	$ 0.15	$ 0.28	$ 0.22	$ 0.57
Diluted	$ 0.15	$ 0.28	$ 0.22	$ 0.56
Comprehensive income	$ 4,909	$ 9,369	$ 7,688	$ 20,037
Weighted average common shares and equivalents:				
Basic	33,683	33,534	33,485	33,815
Diluted	34,068	34,178	33,706	34,525

See accompanying notes to the consolidated financial statements.

HEALTHWAYS, INC.
CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY
For the Nine Months Ended September 30, 2012
(In thousands)
(Unaudited)

	Preferred Stock	Common Stock	Additional Paid-in Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Loss	Total
Balance, December 31, 2011	$—	$33	$247,137	$48,517	$(28,182)	$(1,789)	$265,716
Comprehensive income	—	—	—	7,420	—	268	7,688
Exercise of stock options	—	1	2,834	—	—	—	2,835
Tax effect of stock options and restricted stock units	—	—	(4,453)	—	—	—	(4,453)
Share-based employee compensation expense	—	—	4,652	—	—	—	4,652
Other	—	—	58	—	—	—	58
Balance, September 30, 2012	$—	$34	$250,228	$55,937	$(28,182)	$(1,521)	$276,496

See accompanying notes to the consolidated financial statements.

HEALTHWAYS, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Nine Months Ended September 30, 2012	2011
Cash flows from operating activities:		
Net income	$ 7,420	$ 19,377
Adjustments to reconcile net income to net cash flows provided by operating activities, net of business acquisitions:		
Depreciation and amortization	38,233	37,343
Amortization and write-off of deferred loan costs	2,077	1,431
Share-based employee compensation expense	4,652	6,803
Deferred income taxes	(1,517)	(2,728)
Excess tax benefits from share-based payment arrangements	(477)	(433)
Increase in accounts receivable, net	(17,081)	(3,554)
Decrease in other current assets	779	6,396
Decrease in accounts payable	(6,029)	(588)
Decrease in accrued salaries and benefits	(14,454)	(14,361)
Increase in other current liabilities	12,912	9,400
Other	(3,124)	(756)
Net cash flows provided by operating activities	23,391	58,330
Cash flows from investing activities:		
Acquisition of property and equipment	(40,735)	(33,508)
Business acquisitions, net of cash acquired	(4,693)	(23,523)
Other	(6,075)	(5,085)
Net cash flows used in investing activities	(51,503)	(62,116)
Cash flows from financing activities:		
Proceeds from issuance of long-term debt	653,874	350,422
Payments of long-term debt	(631,315)	(321,393)
Deferred loan costs	(2,547)	—
Excess tax benefits from share-based payment arrangements	477	433
Exercise of stock options	2,835	4,812
Repurchases of common stock	—	(23,690)
Change in outstanding checks and other	6,471	(1,320)
Net cash flows provided by financing activities	29,795	9,264
Effect of exchange rate changes on cash	24	94
Net increase in cash and cash equivalents	1,707	5,572
Cash and cash equivalents, beginning of period	864	1,064
Cash and cash equivalents, end of period	$ 2,571	$ 6,636

See accompanying notes to the consolidated financial statements.

HEALTHWAYS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

(1) Basis of Presentation

Our financial statements and accompanying notes are prepared in accordance with accounting principles generally accepted in the United States of America ("U.S. GAAP"). In our opinion, the accompanying consolidated financial statements of Healthways, Inc. and its wholly-owned subsidiaries ("Healthways", the "Company", or such terms as "we," "us," or "our") reflect all adjustments consisting of normal, recurring accruals necessary for a fair presentation. We have reclassified certain items in prior periods to conform to current classifications.

We have omitted certain financial information that is normally included in financial statements prepared in accordance with U.S. GAAP but that is not required for interim reporting purposes. You should read the accompanying consolidated financial statements in conjunction with the financial statements and notes thereto included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011.

(2) Recent Accounting Standards

In June 2011, the Financial Accounting Standards Board (the "FASB") issued Accounting Standards Update ("ASU") No. 2011-05, "Presentation of Comprehensive Income". This standard eliminates the option to report other comprehensive income and its components in the statement of changes in stockholders' equity and requires an entity to present net income and other comprehensive income in one continuous statement or in two separate but consecutive statements. In December 2011, the FASB issued ASU No. 2011-12, "Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05", which defers the requirement to present on the face of the financial statements reclassification adjustments for items that are reclassified from other comprehensive income to net income while the FASB further deliberates this aspect of the proposal. ASU No. 2011-05, as amended by ASU No. 2011-12, is effective for interim and annual reporting periods beginning after December 15, 2011. We adopted this standard for the interim period beginning January 1, 2012 and elected to present net income and other comprehensive income in one continuous statement. The adoption of this standard did not have an impact on our consolidated results of operations, financial position, cash flows, or notes to the consolidated financial statements.

In July 2012, the FASB issued ASU No. 2012-02, "Intangibles—Goodwill and Other (Topic 350)—Testing Indefinite-Lived Intangible Assets for Impairment". ASU No. 2012-02 permits an entity to perform a qualitative assessment to determine whether it is more likely than not that the fair value of an indefinite-lived intangible asset is less than its carrying value. If the entity concludes that this is the case, it must perform the currently prescribed quantitative impairment test by comparing the fair value of the indefinite-lived intangible asset with its carrying value. Otherwise, the quantitative impairment test is not required. ASU No. 2012-02 is effective for fiscal years beginning after September 15, 2012, with earlier adoption permitted. We do not expect the adoption of this standard to have a material impact on our consolidated results of operations, financial position, cash flows, or notes to the consolidated financial statements.

(3) Share-Based Compensation

We have several stockholder-approved stock incentive plans for our employees and directors. We currently have three types of share-based awards outstanding under these plans: stock options, restricted stock

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units, and restricted stock. We believe that such awards align the interests of our employees and directors with those of our stockholders.

For the three and nine months ended September 30, 2012, we recognized share-based compensation costs of $1.9 million and $4.7 million, respectively. For the three and nine months ended September 30, 2011, we recognized share-based compensation costs of $2.3 million and $6.8 million, respectively.

A summary of our stock options as of September 30, 2012 and changes during the nine months then ended is presented below:

Options	Shares (000s)	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (years)	Aggregate Intrinsic Value ($000s)
Outstanding at January 1, 2012	5,659	$ 17.58		
Granted	837	7.75		
Exercised	(401)	7.23		
Forfeited	(584)	10.60		
Expired	(690)	30.27		
Outstanding at September 30, 2012	4,821	15.77	5.68	$4,770
Exercisable at September 30, 2012	2,696	20.02	3.46	$445

The weighted-average grant-date fair value of options granted during the three and nine months ended September 30, 2012 was $5.10 and $3.97, respectively.

The following table shows a summary of our restricted stock and restricted stock units (“nonvested shares”) as of September 30, 2012, as well as activity during the nine months then ended:

Nonvested Shares	Shares (000s)	Weighted-Average Grant Date Fair Value
Nonvested at January 1, 2012	910	$ 12.22
Granted	404	7.38
Vested	(264)	12.61
Forfeited	(168)	10.75
Nonvested at September 30, 2012	882	$ 9.83

(4) Income Taxes

Our effective tax rate decreased to 41.1% for the three months ended September 30, 2012 compared to 43.5% for the three months ended September 30, 2011, primarily due to a favorable impact on the effective tax rate related to routine reconciliations of tax return filings as well as a favorable impact from the higher relative level of foreign earnings, which are taxed at statutory rates lower than our domestic earnings.

Our effective tax rate remained relatively consistent for the nine months ended September 30, 2012 compared to the nine months ended September 30, 2011.

We file income tax returns in the U.S. federal jurisdiction and in various state and foreign jurisdictions. Tax years remaining subject to examination in these jurisdictions include 2008 to present.

(5) Derivative Investments and Hedging Activities

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

Interest Rate

In order to reduce our exposure to interest rate fluctuations on our floating rate debt commitments, we maintain interest rate swap agreements that effectively modify our exposure to interest rate risk by converting a portion of our floating rate debt to fixed obligations, thus reducing the impact of interest rate changes on future interest expense. Under these agreements, we receive a variable rate of interest based on LIBOR, and we pay a fixed rate of interest with interest rates ranging from 0.370% to 3.385% plus a spread (see Note 7). We maintain interest rate swap agreements with current notional amounts of $475.0 million and termination dates ranging from December 31, 2012 to December 31, 2016. Of this amount, $200.0 million will become effective in 2013, and $50.0 million in 2015, as older interest rate swap agreements expire. We have designated these interest rate swap agreements as qualifying cash flow hedges. We currently meet the hedge accounting criteria under U.S. GAAP in accounting for these interest rate swap agreements.

Foreign Currency

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

Fair Values of Derivative Instruments

The estimated gross fair values of derivative instruments at September 30, 2012 and December 31, 2011, excluding the impact of netting derivative assets and liabilities when a legally enforceable master netting agreement exists, were as follows:

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(In $000s)	September 30, 2012 Foreign currency exchange contracts	September 30, 2012 Interest rate swap agreements	December 31, 2011 Foreign currency exchange contracts	December 31, 2011 Interest rate swap agreements
Assets:				
Derivatives not designated as hedging instruments:				
Other current assets	$115	$—	$315	$—
Total assets	$115	$—	$315	$—
Liabilities:				
Derivatives not designated as hedging instruments:				
Accrued liabilities	$280	$—	$321	$—
Derivatives designated as hedging instruments:				
Accrued liabilities	—	173	—	251
Other long-term liabilities	—	3,484	—	3,984
Total liabilities	$280	$3,657	$321	$4,235

Cash Flow Hedges

Derivative instruments that are designated and qualify as cash flow hedges are recorded at estimated fair value in the consolidated balance sheets, with the effective portion of the gains and losses being reported in accumulated other comprehensive income or loss ("accumulated OCI"). Cash flow hedges for all periods presented consist solely of interest rate swap agreements. Gains and losses on these interest rate swap agreements are reclassified to interest expense in the same period during which the hedged transaction affects earnings or the period in which all or a portion of the hedge becomes ineffective. As of September 30, 2012, we expect to reclassify $2.4 million of net losses on interest rate swap agreements from accumulated OCI to interest expense within the next 12 months due to the scheduled payment of interest associated with our debt.

The following table shows the effect of our cash flow hedges on the consolidated balance sheets during the three and nine months ended September 30, 2012 and September 30, 2011:

(In $000s) Derivatives in Cash Flow Hedging Relationships	For the Three Months Ended September 30, 2012	For the Three Months Ended September 30, 2011	For the Nine Months Ended September 30, 2012	For the Nine Months Ended September 30, 2011
Loss related to effective portion of derivatives recognized in accumulated OCI, gross of tax effect	$1,223	$572	$2,001	$1,983
Loss related to effective portion of derivatives reclassified from accumulated OCI to interest expense, gross of tax effect	$790	$1,160	$2,579	$3,631

Gains and losses representing either hedge ineffectiveness or hedge components excluded from the assessment of effectiveness are recognized in current earnings. During the three and nine months ended September 30, 2012 and

2011, there were no gains or losses on cash flow hedges recognized in our consolidated statements of comprehensive income resulting from hedge ineffectiveness.

Derivative Instruments Not Designated as Hedging Instruments

Our foreign currency exchange contracts require current period mark-to-market accounting, with any change in fair value being recorded each period in the consolidated statements of comprehensive income in selling, general and administrative expenses. At September 30, 2012, we had forward contracts with notional amounts of $13.7 million to exchange foreign currencies, primarily the Australian dollar and Euro, that were entered into in order to hedge forecasted foreign net income (loss) and intercompany debt.

These forward contracts did not have a material effect on our consolidated statements of comprehensive income during the three or nine months ended September 30, 2012 and 2011.

(6) Fair Value Measurements

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

Fair Value Hierarchy

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

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

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

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

Assets and Liabilities Measured at Fair Value on a Recurring Basis

The following tables present our assets and liabilities measured at fair value on a recurring basis at September 30, 2012 and December 31, 2011:

(In $000s) September 30, 2012	Level 2	Gross Fair Value	Netting (1)	Net Fair Value
Assets:				
Foreign currency exchange contracts	$ 115	$ 115	$ (109)	$ 6
Liabilities:				
Foreign currency exchange contracts	$ 280	$ 280	$ (109)	$ 171
Interest rate swap agreements	3,657	3,657	—	3,657

(In $000s) December 31, 2011	Level 2	Gross Fair Value	Netting (1)	Net Fair Value
Assets:				
Foreign currency exchange contracts	$ 315	$ 315	$ (212)	$ 103
Liabilities:				
Foreign currency exchange contracts	$ 321	$ 321	$ (212)	$ 109
Interest rate swap agreements	4,235	4,235	—	4,235

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

The fair values of forward foreign currency exchange contracts are valued using broker quotations of similar assets or liabilities in active markets. The fair values of interest rate swap agreements are primarily determined based on the present value of future cash flows using internal models and third-party pricing services with observable inputs, including interest rates, yield curves and applicable credit spreads.

Fair Value of Other Financial Instruments

In addition to foreign currency exchange contracts and interest rate swap agreements, the estimated fair values of which are disclosed above, the estimated fair value of each class of financial instruments at September 30, 2012 was as follows:

- Cash and cash equivalents – The carrying amount of $2.6 million approximates fair value because of the short maturity of those instruments (less than three months).

- Long-term debt – The estimated fair value of outstanding borrowings under the Fifth Amended and Restated Revolving Credit and Term Loan Agreement (the “Fifth Amended Credit Agreement”), which includes a revolving credit facility and a term loan facility (see Note 7), is determined based on the fair value hierarchy as discussed above. The revolving credit facility and the term loan facility are not actively traded and therefore are classified as Level 2 valuations based on the market for similar instruments. The estimated fair value is based on the average of the prices set by the issuing bank given current market conditions and is not necessarily indicative of the amount we could realize in a current market exchange. The estimated fair value and carrying amount of outstanding borrowings under the Fifth Amended Credit Agreement at September 30, 2012 are $289.6 million and $290.3 million, respectively. Under the Fourth Amended and Restated Credit Agreement, which was in effect through June 7, 2012, the term loan was actively traded and was classified as a Level 1 valuation based on the market for identical instruments.

(7) Long-Term Debt

On June 8, 2012, we entered into the Fifth Amended Credit Agreement. The Fifth Amended Credit Agreement provides us with a $200.0 million revolving credit facility that expires June 8, 2017 and includes a swingline sub facility of $20.0 million and a $75.0 million sub facility for letters of credit. The Fifth Amended Credit Agreement also provides a $200.0 million term loan facility that matures on June 8, 2017, all of which remained outstanding on September 30, 2012, and an uncommitted incremental accordion facility of $200.0 million. As of September 30, 2012, availability under the revolving credit facility totaled $71.9 million as calculated under the most restrictive covenant.

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Borrowings under the Fifth Amended Credit Agreement generally bear interest at variable rates based on a margin or spread in excess of either (1) the one-month, two-month, three-month or six-month rate (or with the approval of affected lenders, nine-month or twelve-month rate) for Eurodollar deposits ("LIBOR") or (2) the greatest of (a) the prime lending rate, (b) the federal funds rate plus 0.50%, and (c) one-month LIBOR plus 1.00% (the "Base Rate"), as selected by the Company. The LIBOR margin varies between 1.75% and 3.00%, and the Base Rate margin varies between 0.75% and 2.00%. The Fifth Amended Credit Agreement also provides for an annual fee ranging between 0.30% and 0.50% of the unused commitments under the revolving credit facility. The Fifth Amended Credit Agreement is secured by guarantees from all of the Company's active domestic subsidiaries and by security interests in substantially all of the Company's and such subsidiaries' assets.

We are required to repay outstanding revolving loans under the revolving credit facility on June 8, 2017. We are required to repay term loans in quarterly principal installments aggregating (1) 1.250% of the original aggregate principal amount of the term loans during each of the first eight quarters following the closing, (2) 1.875% of the original aggregate principal amount of the term loans during each of the next four quarters following the closing, (3) 2.500% of the original aggregate principal amount of the term loans during each of the remaining quarters prior to maturity on June 8, 2017, at which time the entire unpaid principal balance of the term loans is due and payable.

The Fifth Amended Credit Agreement contains various financial covenants, which require us to maintain, as defined therein, ratios or levels of 1) total funded debt to EBITDA and 2) fixed charge coverage. The Fifth Amended Credit Agreement also limits the amount of dividends and repurchases of the Company's common stock. As of September 30, 2012, we were in compliance with all of the covenant requirements of the Fifth Amended Credit Agreement.

As described in Note 5 above, as of September 30, 2012, we are a party to interest rate swap agreements for which we receive a variable rate of interest based on LIBOR and for which we pay a fixed rate of interest.

(8) Restructuring and Related Charges

In November 2011, we began a restructuring of the Company (the "2011 Restructuring"), which was largely completed by the end of fiscal 2011, primarily focused on aligning our capacity requirements and organizational structure following CIGNA's decision to wind-down its contract beginning in 2012. We do not expect to incur significant additional costs or adjustments related to this restructuring.

In November 2010, we began a restructuring of the Company (the "2010 Restructuring"), which was largely completed by the end of fiscal 2010, primarily focused on aligning resources with current and emerging markets and consolidating operating capacity. We do not expect to incur significant additional costs or adjustments related to this restructuring.

The change in accrued restructuring and related charges associated with the 2011 Restructuring and 2010 Restructuring activities described above during the nine months ended September 30, 2012 were as follows:

(In 000s)	2011 Restructuring	2010 Restructuring	Total
Accrued restructuring and related charges at January 1, 2012	$ 8,426	$ 1,583	$ 10,009
Payments	(6,935)	(608)	(7,543)
Adjustments (1)	(502)	(102)	(604)
Accrued restructuring and related charges at September 30, 2012	$ 989	$ 873	1,862

(1) Adjustments for the nine months ended September 30, 2012 resulted primarily from actual employee tax and benefit amounts differing from previous estimates.

(9) Commitments and Contingencies

Contract Dispute

We currently are involved in a contractual dispute with Blue Cross Blue Shield of Minnesota regarding fees paid to us as part of a former contractual relationship. On January 25, 2010, Blue Cross Blue Shield of Minnesota issued notice of arbitration with the American Arbitration Association in Minneapolis alleging a violation of certain contract provisions. We believe we performed our services in compliance with the terms of our agreement and that the assertions made in the arbitration notice are without merit. On August 3, 2011, we asserted numerous counterclaims against Blue Cross Blue Shield of Minnesota. We are not able to reasonably estimate a range of potential losses, if any.

Anti-Trust Lawsuit

On May 1, 2012, American Specialty Health Group (“ASH”) amended a claim (the “Amended Claim”) that it had previously filed against the Company in the U.S. District Court in the Southern District of California (“Court”) on December 2, 2011 (the “Original Claim”). The Original Claim alleged that the Company’s exclusivity provisions in some of its contracts with participating locations in its SilverSneakers fitness network violate California’s Unfair Competition Law (“UCL”) and that the Company interfered with ASH’s contractual relations and prospective economic advantages. The Amended Claim added allegations that the Company is in violation of the Sherman Antitrust Act (the “Act”) because such exclusivity provisions create illegal restraints on trade and constitute monopolization or attempted monopolization in violation of the Act. Under the Amended Claim, ASH is seeking damages in excess of $15,000,000, treble damages under the Act, and injunctive relief. The Company has asserted counterclaims against ASH for interference and violation of the UCL, and on October 12, 2012, the Court granted the Company’s motion to add an additional counterclaim that ASH has falsely advertised the composition of its fitness facility network in violation of the Lanham Act.

We believe ASH’s claims are without merit and intend to vigorously defend ourselves against the Amended Claim.

Performance Award Lawsuit

On September 4, 2012, Milton Pfeiffer (“Plaintiff”), claiming to be a stockholder of the Company, filed a putative derivative action against the Company and the Board of Directors in Delaware Chancery Court

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alleging that the Compensation Committee and the Board of Directors breached their fiduciary duties and violated the Company's 2007 Stock Incentive Plan (the "Plan") by granting Ben R. Leedle, Jr., Chief Executive Officer and President of the Company, a discretionary performance award under the Plan of 500,000 shares (the "Performance Award"), which consisted of 365,000 performance awards issued in November 2011 and 135,000 performance awards issued in February 2012. Plaintiff alleges that the Performance Award exceeded what is authorized by the Plan and that the Company's 2012 proxy statement, in which the Performance Award is disclosed, is false and misleading. Plaintiff also alleges that Mr. Leedle breached his fiduciary duties and was unjustly enriched by receiving the Performance Award. Plaintiff is seeking, inter alia, the rescission or disgorgement of all alleged "excess" awards granted to Mr. Leedle under the Performance Award, to recover any incidental damages to the Company, and an award of attorneys' fees and expenses. We believe Plaintiff's claims are without merit and intend to vigorously defend ourselves against the action.

Outlook

We are also subject to other contractual disputes, claims and legal proceedings that arise from time to time in the ordinary course of our business. While we are unable to estimate a range of potential losses, we do not believe that any of the legal proceedings pending against us as of the date of this report will have a material adverse effect on our liquidity or financial condition. As these matters are subject to inherent uncertainties, our view of these matters may change in the future.

Contractual Commitment

In May 2011, we entered into a ten-year applications and technology services outsourcing agreement with HP Enterprise Services, LLC that contains minimum fee requirements. Total payments over the remaining term, including an estimate for future contractual cost of living adjustments, must equal or exceed a minimum level of approximately $166.8 million; however, based on initial required service and equipment level assumptions, we estimate that the remaining payments will be approximately $342.8 million. The agreement allows us to terminate all or a portion of the services after the first two years provided we pay certain termination fees, which could be material to the Company.

(10) Share Repurchases

The Company's Board of Directors authorized a share repurchase program, which was publicly announced on October 21, 2010. The share repurchase program allows for the repurchase of up to $60 million of our common stock from time to time in the open market or in privately negotiated transactions through October 19, 2012. No shares were repurchased between July 1, 2012 and September 30, 2012 pursuant to the program.

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs
July 1 through 31, 2012	—	—	2,254,953	$31,813,383
August 1 through 31, 2012	—	—	2,254,953	$31,813,383
	—	—	2,254,953	$31,813,383

September 1 through 30, 2012	
Total	—

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(11) Earnings Per Share

The following is a reconciliation of the numerator and denominator of basic and diluted earnings per share for the three and nine months ended September 30, 2012 and 2011:

(In 000s, except per share data)	Three Months Ended September 30, 2012	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2011
Numerator:				
Net income - numerator for basic earnings per share	$ 5,028	$ 9,464	$ 7,420	$ 19,377
Denominator:				
Shares used for basic earnings per share	33,683	33,534	33,485	33,815
Effect of dilutive securities outstanding:				
Non-qualified stock options	127	322	50	379
Restricted stock units	258	322	171	331
Shares used for diluted earnings per share	34,068	34,178	33,706	34,525
Earnings per share:				
Basic	$ 0.15	$ 0.28	$ 0.22	$ 0.57
Diluted	$ 0.15	$ 0.28	$ 0.22	$ 0.56
Dilutive securities outstanding not included in the computation of earnings per share because their effect is antidilutive:				
Non-qualified stock options	4,339	4,082	5,146	4,234
Restricted stock units	124	183	236	138

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

Overview

Founded in 1981, Healthways provides specialized, comprehensive solutions to help people improve physical, emotional and social well-being, thereby improving their health and productivity and reducing their health-related costs.

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

In North America, our customers include health plans, employers, integrated healthcare systems, hospitals, physicians, and government entities in all 50 states, the District of Columbia and Puerto Rico. We also provide services to commercial healthcare businesses and/or government entities in Brazil, Australia and France. We operate domestic and international well-being improvement centers staffed with licensed health professionals. Our fitness center network encompasses approximately 15,000 U.S. locations. We also maintain an extensive network of over 88,000 complementary, alternative and physical medicine practitioners, which offers convenient access to the significant number of individuals who seek health services outside of the traditional healthcare system.

Our guiding philosophy and approach to market is predicated on the fundamental belief that healthier people cost less and are more productive. As described more fully below, our programs are designed to improve well-being by helping people to adopt or maintain healthy behaviors, reduce health-related risk factors, and optimize care for identified health conditions.

First, our programs are designed to help people adopt or maintain healthy behaviors by:

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

Our prevention programs focus on education, physical fitness, health coaching, and behavior change techniques and support. We believe this approach improves the well-being status of member populations and reduces the short- and long-term health-related costs for participants, including associated costs from the loss of employee productivity.

Second, our programs are designed to help people reduce health-related risk factors by:

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

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

Finally, our programs are designed to help people optimize care for identified health conditions by:

- incorporating the latest, evidence-based clinical guidelines into interventions to optimize patient health outcomes;
- developing care support plans and motivating members to set attainable goals for themselves;
- providing local market resources to address acute episodic interventions;
- coordinating members' care with their healthcare providers;
- providing software licensing and management consulting in support of well-being improvement services; and
- providing high-risk care management for members at risk for hospitalization due to complex conditions.

Our approach is to use proprietary, analytic models to identify individuals who are likely to incur future high costs, including those who have specific gaps in care, and through evidence-based interventions drive adherence to proven standards of care, medication regimens and physicians' plans of care to reduce disease progression and related medical spending.

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

Forward-Looking Statements

Management's Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements, which are based upon current expectations, involve a number of risks and uncertainties, and are subject to the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements include all statements that are not historical statements of fact and those regarding the intent, belief, or expectations of the Company, including, without limitation, all statements regarding the Company's future earnings and results of operations, and can be identified by the use of words like "may," "believe," "will," "expect," "project," "estimate," "anticipate, or "continue" and similar expressions. Those forward-looking statements may be affected by certain risks and uncertainties, including, but not limited to:

- our ability to sign and implement new contracts for our solutions;
- our ability to accurately forecast the costs required to successfully implement new contracts;
- our ability to renew and/or maintain contracts with our customers under existing terms or restructure these contracts on terms that would not have a material negative impact on our results of operations;
- our ability to effectively compete against other entities, whose financial, research, staff, and marketing resources may exceed our resources;
- our ability to accurately forecast the Company's revenues, margins, earnings and net income, as well as any potential charges that we may incur as a result of changes in our business;

- our ability to accurately forecast variables that affect performance and the timing of revenue recognition under the terms of our customer contracts ahead of data collection and reconciliation;
- the impact of the Patient Protection and Affordable Care Act, as amended by the Health Care and Education Reconciliation Act of 2010 (“PPACA”), on our operations and/or the demand for our services;
- the impact of any new or proposed legislation, regulations and interpretations relating to the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, including the potential expansion to Phase II for Medicare Health Support programs and any legislative or regulatory changes with respect to Medicare Advantage;
- our ability to anticipate the rate of market acceptance of our solutions in potential international markets;
- our ability to accurately forecast the costs necessary to establish a presence in international markets;
- the risks associated with foreign currency exchange rate fluctuations and our ability to hedge against such fluctuations;
- the risks associated with deriving a significant concentration of our revenues from a limited number of customers;
- our ability to achieve and reach mutual agreement with customers with respect to contractually required performance metrics, cost savings and clinical outcomes improvements, or to achieve such metrics, savings and improvements within the time frames contemplated by us;
- our ability to achieve estimated annualized revenue in backlog in the manner and within the timeframe we expect, which is based on certain estimates regarding the implementation of our services;
- our ability and/or the ability of our customers to enroll participants and to estimate their level of enrollment and participation in our programs in a manner and within the timeframe anticipated by us;
- the ability of our customers to provide timely and accurate data that is essential to the operation and measurement of our performance under the terms of our contracts;
- our ability to favorably resolve contract billing and interpretation issues with our customers;
- our ability to service our debt, make principal and interest payments as those payments become due, and remain in compliance with our debt covenants;
- the risks associated with changes in macroeconomic conditions, which may reduce the demand and/or the timing of purchases for our services from customers or potential customers, reduce the number of covered lives of our existing customers, or restrict our ability to obtain additional financing;
- counterparty risk associated with our interest rate swap agreements and foreign currency exchange contracts;
- our ability to integrate acquired businesses, services (including outsourced services), or technologies into our business and to accurately forecast the related costs;
- our ability to anticipate and respond to strategic changes, opportunities, and trends in our industry and/or business and to accurately forecast the related impact on our earnings;
- the impact of any impairment of our goodwill or other intangible assets;
- our ability to develop new products and deliver outcomes on those products;
- our ability to implement our integrated data and technology solutions platform within the required timeframe and expected cost estimates and to develop and enhance this platform and/or other technologies to meet evolving customer and market needs;
- our ability to obtain adequate financing to provide the capital that may be necessary to support our operations and to support or guarantee our performance under new contracts;
- unusual and unforeseen patterns of healthcare utilization by individuals with diseases or conditions for which we provide services;
- the ability of our customers to maintain the number of covered lives enrolled in the plans during the terms of our agreements;
- the impact of legal proceedings involving us and/or our subsidiaries;

- the impact of future state, federal, and international legislation and regulations applicable to our business, including PPACA, on our ability to deliver our services and on the financial health of our customers and their willingness to purchase our services;
- current geopolitical turmoil, the continuing threat of domestic or international terrorism, and the potential emergence of a health pandemic; and
- other risks detailed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011 and other filings with the Securities and Exchange Commission.

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

Contract Terms

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

Our contracts with health plans generally range from three to five years with provisions for subsequent renewal; contracts with self-insured employers typically have one to three-year terms. Some of our contracts allow the customer to terminate early.

Some of our contracts place a portion of our fees at risk based on achieving certain performance metrics, cost savings, and/or clinical outcomes improvements ("performance-based"). Approximately 7% of revenues recorded during the nine months ended September 30, 2012 were performance-based and were subject to final reconciliation as of September 30, 2012.

Technology

Our solutions require sophisticated analytical, data management, Internet and computer-telephony solutions based on state-of-the-art technology. These solutions help us deliver our services to large populations within our customer base. Our predictive modeling capabilities allow us to identify and stratify those participants who are most at risk for an adverse health event. We incorporate behavior-change science with consumer-friendly interactions to facilitate consumer preferences for engagement and convenience. We use sophisticated data analytical and reporting solutions to validate the impact of our programs on clinical and financial outcomes. We continue to invest heavily in technology, as evidenced by our long-term applications and technology services outsourcing agreement with HP Enterprise Services, LLC, and are continually expanding and improving our proprietary clinical, data management, and reporting systems to continue to meet the information management requirements of our services. The behavior change techniques and predictive modeling incorporated in our technology identify an individual's readiness to change and provide personalized support through appropriate interactions using a range of methods desired by an individual, including venue-based face-to-face; print; phone; mobile and remote devices; on-line; emerging modalities; and any combination thereof to motivate and sustain healthy behaviors.

Business Strategy

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

Our business strategy reflects our passion to enhance health and well-being and, as a result, reduce

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overall healthcare costs and improve workforce engagement, yielding better business performance for our customers. Our solutions are designed to improve well-being by helping people to:

- adopt or maintain healthy behaviors;
- reduce health-related risk factors; and
- optimize care for identified health conditions.

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

We believe it is critical to impact an entire population's underlying health status and well-being in a long-term, cost effective way. Believing that what gets measured gets acted upon, in 2008, we entered into an exclusive, 25-year relationship with Gallup to create a definitive measure and empiric database of changes in the well-being of the U.S. population, known as the Gallup-Healthways Well-Being Index® ("WBI"), as well as processes to establish benchmarking for purposes of comparing the well-being of any subset of the national population. The responses to the nearly 1.8 million completed WBI surveys to date have provided Gallup and us with an unmatched database to support our mutual goal of understanding the causes and effects of well-being for a population. This relationship was expanded in 2011 with the launch of the Gallup-Healthways Well-Being Index in the United Kingdom and Germany, indicating a growing global interest in gaining clear insights for government and business leaders charged with shaping the policy responses necessary to improve health, increase individual and organizational performance, lower healthcare costs and achieve sustained economic growth. In October 2012 we created a global joint venture with Gallup that will develop the next generation of Gallup-Healthways individual well-being assessment tools to provide employers, health providers, insurers and other interested parties with validated tools to assess, measure and report on changes in the well-being of their employees, patients, members and customers. Under the joint venture agreement, we will acquire an increasing equity interest in the joint venture over a five-year period beginning in January 2013. We have contractual cash obligations of $6.5 million per year for the first three years of the agreement and between $5.0 million and $8.0 million for each of the final two years of the agreement (such amounts to be determined during the fourth quarter of 2015).

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

We are adding and enhancing solutions to extend our reach and effectiveness and to meet increasing demand for integrated solutions. The flexibility of our programs allows customers to provide a range of services they deem appropriate for their organizations. Customers may select from certain single program options up to a total-population approach, in which all members of a customer's population are eligible to receive our services. Recently signed contracts have expanded both the level of integration and breadth of services provided to major health plans as they develop and implement a number of patient-centered medical home models. Our services extend beyond chronic care and wellness programs to include care management and pharmacy benefit management, as well as health promotion, prevention and quality improvement solutions.

Our strategy includes, as a priority, the ongoing expansion of our value proposition through our total population management solution. This solution, in addition to improving individuals' health and reducing direct

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healthcare costs, targets a much larger improvement in employer profitability by reducing the impact of lost productivity for health-related reasons. With the success of our total population management solution, we expect to gain an even greater competitive advantage in responding to employers' needs for a healthier, higher-performing and less costly workforce.

Our strategy also includes the further enhancement and deployment of our proprietary next generation technology platform known as Embrace™. This platform, which is essential to our total population management solution, enables us to integrate data from the healthcare organizations and other entities interacting with an individual. Embrace provides for the delivery of our integrated solutions and ongoing communications between the individual and his or her medical and health experts, using a range of methods, including venue-based face-to-face; print; phone; mobile and remote devices; on-line; emerging modalities; and any combination thereof.

Significant changes in government regulation of healthcare continue to afford us expanding opportunities to provide services to integrated healthcare systems, hospitals, and physicians in addition to health plans and employers. In 2011 we acquired Navvis & Company, a well-established provider of strategic counsel and change management services enabling its healthcare system clients to become future-ready clinical enterprises within healthcare's rapidly emerging value-based reimbursement system. Our strategy includes providing integrated healthcare systems, hospitals, and physician enterprises both consultative strategic planning services and a range of capabilities that enable and support the delivery of Physician-Directed Population Health solutions.

We plan to increase our competitive advantage in delivering our services by leveraging the scope of our capabilities, including our medical information content, behavior change processes and techniques, strategic relationships, health provider networks, and fitness center relationships. We also plan to continue to scale the delivery of our solutions employing a blend of our scalable, state-of-the-art well-being improvement centers and proprietary technologies, modalities, and techniques. We may add new capabilities and technologies through internal development, strategic alliances with other entities, and/or selective acquisitions or investments. Examples include our collaboration with Blue Zones, LLC in delivering a scaled well-being improvement solution to support the Healthiest State initiative in Iowa; our investment in our wholly-owned subsidiary MeYou Health, LLC in bringing to market well-being improvement tools in the social media space through web and personal device delivery methods; and our recently expanded strategic relationship with Johns Hopkins Medicine to commercialize the sustained weight loss program Innergy resulting from a three-year clinical trial conducted by the National Heart, Lung and Blood Institute.

We anticipate continuing to enhance, expand and integrate additional capabilities with health plans and integrated healthcare systems and to pursue opportunities with employers, domestic government entities, and communities, as well as the public and private sectors of healthcare in international markets.

Critical Accounting Policies

We describe our accounting policies in Note 1 of the Notes to the Consolidated Financial Statements in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011. We prepare the consolidated financial statements in conformity with U.S. GAAP, which requires us to make estimates and judgments that affect the reported amounts of assets and liabilities and related disclosures at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results may differ from those estimates.

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

Revenue Recognition

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

Our contracts with health plans generally range from three to five years with provisions for subsequent renewal; contracts with self-insured employers typically have one to three-year terms. Some of our contracts allow the customer to terminate early.

Some of our contracts place a portion of our fees at risk based on achieving certain performance metrics, cost savings, and/or clinical outcomes improvements ("performance-based"). Approximately 7% of revenues recorded during the nine months ended September 30, 2012 were performance-based and were subject to final reconciliation as of September 30, 2012.

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

We generally bill our customers each month for the entire amount of the fees contractually due for the prior month's enrollment, which typically includes the amount, if any, that is performance-based and may be subject to refund should we not meet performance targets. Fees for service are typically billed in the month after the services are provided. Deferred revenues arise from contracts that permit upfront billing and collection of fees covering the entire contractual service period, generally 12 months. A limited number of our contracts provide for certain performance-based fees that cannot be billed until after they are reconciled with the customer.

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

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

During the settlement process under a contract, which generally occurs six to eight months after the end of a contract year, we settle any performance-based fees and reconcile healthcare claims and clinical data. As of

September 30, 2012, cumulative performance-based revenues that have not yet been settled with our customers but that have been recognized in the current and prior years totaled approximately $56.2 million, all of which were based on actual data received from our customers. Data reconciliation differences, for which we provide contractual allowances until we reach agreement with respect to identified issues, can arise between the customer and us due to customer data deficiencies, omissions, and/or data discrepancies.

Performance-related adjustments (including any amounts recorded as revenue that were ultimately refunded), changes in estimates, or data reconciliation differences may cause us to recognize or reverse revenue in a current fiscal year that pertains to services provided during a prior fiscal year. During the nine months ended September 30, 2012, we recognized a net increase in revenue of $8.0 million that related to services provided prior to 2012.

Impairment of Intangible Assets and Goodwill

We review goodwill for impairment at the reporting unit level (operating segment or one level below an operating segment) on an annual basis or more frequently whenever events or circumstances indicate that the carrying value may not be recoverable. We may elect to perform a qualitative assessment to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying value. If we conclude during the qualitative assessment that this is the case, we perform a quantitative review as described below. Otherwise, we do not perform a quantitative review. If we elect not to perform a qualitative assessment, then we proceed to the quantitative review described below.

During a quantitative review of goodwill, we estimate the fair value of each reporting unit using a combination of a discounted cash flow model and a market-based approach, and we reconcile the aggregate fair value of our reporting units to our consolidated market capitalization. Estimating fair value requires significant judgments, including management’s estimate of future cash flows, which is dependent on internal forecasts, estimation of the long-term growth rate for our business, the useful life over which cash flows will occur, and determination of our weighted average cost of capital, as well as relevant comparable company earnings multiples for the market-based approach. Changes in these estimates and assumptions could materially affect the estimate of fair value and potential goodwill impairment for each reporting unit.

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

Except for a certain trade name that has an indefinite life and is not subject to amortization, we amortize identifiable intangible assets, such as acquired technologies and customer contracts, using the straight-line method over their estimated useful lives. We assess the potential impairment of intangible assets subject to amortization whenever events or changes in circumstances indicate that the carrying values may not be recoverable. If we determine that the carrying value of other identifiable intangible assets may not be recoverable, we calculate any impairment using an estimate of the asset’s fair value based on the estimated price that would be received to sell the asset in an orderly transaction between market participants.

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

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

Income Taxes

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

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

Share-Based Compensation

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

Results of Operations

The following table shows the components of the consolidated statements of comprehensive income for the three and nine months ended September 30, 2012 and 2011 expressed as a percentage of revenues.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Revenues	100.0%	100.0%	100.0%	100.0%
Cost of services (exclusive of depreciation and amortization included below)	76.1 %	73.5 %	78.9%	74.2%
Selling, general and administrative expenses	8.8 %	8.1 %	8.7%	9.8%
Depreciation and amortization	8.0 %	7.1 %	7.6%	7.3%
Operating income	7.1 %	11.3 %	4.8%	8.7%
Interest expense	2.0 %	1.8 %	2.2%	1.9%
Income before income taxes	5.1 %	9.5 %	2.6%	6.8%
Income tax expense	2.1 %	4.1 %	1.1%	2.9%
Net income (1)	3.0 %	5.4 %	1.5%	3.8%

(1) Figures may not add due to rounding.

Revenues

Revenues decreased $9.6 million and $6.8 million, or 5.5% and 1.3%, for the three and nine months ended September 30, 2012 compared to the same periods in 2011, primarily due to decreases in revenue from the wind-down of our contract with CIGNA in advance of the contract's expiration in February 2013, as well as certain other contract or program terminations with three smaller health plan customers. These decreases were somewhat offset by the following:

- an increase in participation in our fitness solutions, as well as in the number of members eligible to participate in such programs;
- the commencement of contracts with new customers; and
- an increase in performance-based revenues due to our ability to measure and achieve performance targets on certain contracts during the three and nine months ended September 30, 2012.

Cost of Services

Cost of services (excluding depreciation and amortization) as a percentage of revenues increased to 76.1% and 78.9% for the three and nine months ended September 30, 2012, respectively, compared to 73.5% and 74.2% for the three and nine months ended September 30, 2011, respectively, primarily due to the following:

- the wind-down of our contract with CIGNA and certain other contract or program terminations with three smaller health plan customers to whom we provided traditional disease management services, all of which carried a lower than average cost of services as a percentage of revenues;
- increased costs related to the launch of new business in the evolving health systems market; and
- an expanded and extended contract during the three and nine months ended September 30, 2012 which moved from a cost-plus model to a volume-based model in which revenues are expected to ramp over time, while the underlying cost structure remained consistent with the three and nine months ended September 30, 2011.

These increases were partially offset by decreases in cost of services (excluding depreciation and amortization) as a percentage of revenues due to the following:

- an increase in performance-based revenues wherein a significant portion of the related costs were incurred and recognized in a prior period;
- costs associated with implementing a new and innovative contract in 2011 for which we weren't able to recognize revenue until 2012;
- decreased costs associated with an initiative during the three months ended September 30, 2011 to promote member participation in certain of our programs; and
- efficiencies gained in our fitness solutions through certain cost management initiatives.

Selling, General and Administrative Expenses

Selling, general and administrative expenses as a percentage of revenues increased to 8.8% for the three months ended September 30, 2012 compared to 8.1% for the three months ended September 30, 2011 primarily due to increased legal fees related to new and ongoing legal proceedings.

Selling, general and administrative expenses as a percentage of revenues decreased to 8.7% for the nine months ended September 30, 2012 compared to 9.8% for the nine months ended September 30, 2011 primarily due to a restructuring of the Company that was largely completed during the fourth quarter of 2011.

Depreciation and Amortization

Depreciation and amortization expense increased $0.8 million and $0.9 million for the three and nine months ended September 30, 2012 compared to the same periods in 2011, primarily due to increased depreciation expense related to our Embrace platform.

Interest Expense

Interest expense remained relatively consistent for the three months ended September 30, 2012 compared to the three months ended September 30, 2011. For the nine months ended September 30, 2012, interest expense increased $1.0 million compared to the same period in 2011, primarily due to the write-off of previously deferred loan costs as a result of entering into the Fifth Amended Credit Agreement on June 8, 2012.

Income Tax Expense

Our effective tax rate decreased to 41.1% for the three months ended September 30, 2012 compared to 43.5% for the three months ended September 30, 2011, primarily due to a favorable impact on the effective tax rate related to routine reconciliations of tax return filings as well as a favorable impact from the higher relative level of foreign earnings, which are taxed at statutory rates lower than our domestic earnings.

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Our effective tax rate remained relatively consistent for the nine months ended September 30, 2012 compared to the nine months ended September 30, 2011.

Outlook

We anticipate that revenues for 2012 will decrease slightly compared to 2011 primarily due to the wind-down of our current contract with CIGNA in advance of the contract's expiration in February 2013 and the expansion and extension of a certain contract during the three months ended September 30, 2012 which moved from a cost-plus model to a volume-based model in which revenues are expected to ramp over time. We expect these decreases will be mostly offset by increased revenues from new and expanded contracts and an increase in participation in our fitness solutions, as well as in the number of members eligible to participate in such solutions.

We expect cost of services (excluding depreciation and amortization) as a percentage of revenues for 2012 to increase compared to 2011 primarily due to the wind-down of our current contract with CIGNA and certain contract or program terminations with three smaller health plan customers to whom we provided traditional disease management services, all of which carried a lower than average cost of services as a percentage of revenues. We expect selling, general and administrative expenses as a percentage of revenues for 2012 to decrease slightly compared to 2011 primarily due to cost savings from a restructuring of the Company that was largely completed during the fourth quarter of 2011. We anticipate depreciation and amortization expense for 2012 will increase compared to 2011 primarily due to continued investment in our Embrace platform.

As discussed in "Liquidity and Capital Resources" below, a significant portion of our long-term debt is subject to fixed interest rate swap agreements; however, we cannot predict the potential for changes in interest rates, which would impact our variable rate debt.

Liquidity and Capital Resources

Operating activities for the nine months ended September 30, 2012 provided cash of $23.4 million compared to $58.3 million for the nine months ended September 30, 2011, primarily due to the following:

- a decrease in net income;
- an increase in days sales outstanding from 50 days at September 30, 2011 to 57 days at September 30, 2012;
- an increase in certain long-term incentive and other benefit payments; and
- an increase in severance payments in 2012 made as a result of a restructuring of the Company that was largely completed during the fourth quarter of 2011.

Investing activities during the nine months ended September 30, 2012 used $51.5 million in cash, which primarily consisted of capital expenditures associated with our Embrace platform.

Financing activities during the nine months ended September 30, 2012 provided $29.8 million in cash, primarily due to net borrowings under our credit agreement.

On June 8, 2012, we entered into the Fifth Amended Credit Agreement. The Fifth Amended Credit Agreement provides us with a $200.0 million revolving credit facility that expires June 8, 2017 and includes a swingline sub facility of $20.0 million and a $75.0 million sub facility for letters of credit. The Fifth Amended Credit Agreement also provides a $200.0 million term loan facility that matures on June 8, 2017, all of which remained outstanding on September 30, 2012, and an uncommitted incremental accordion facility of $200.0

million. As of September 30, 2012, availability under the revolving credit facility totaled $71.9 million as calculated under the most restrictive covenant.

Borrowings under the Fifth Amended Credit Agreement generally bear interest at variable rates based on a margin or spread in excess of either (1) the one-month, two-month, three-month or six-month rate (or with the approval of affected lenders, nine-month or twelve-month rate) for Eurodollar deposits (“LIBOR”) or (2) the greatest of (a) the prime lending rate, (b) the federal funds rate plus 0.50%, and (c) one-month LIBOR plus 1.00% (the “Base Rate”), as selected by the Company. The LIBOR margin varies between 1.75% and 3.00%, and the Base Rate margin varies between 0.75% and 2.00%. The Fifth Amended Credit Agreement also provides for an annual fee ranging between 0.30% and 0.50% of the unused commitments under the revolving credit facility. The Fifth Amended Credit Agreement is secured by guarantees from all of the Company’s active domestic subsidiaries and by security interests in substantially all of the Company’s and such subsidiaries’ assets.

We are required to repay outstanding revolving loans under the revolving credit facility on June 8, 2017. We are required to repay term loans in quarterly principal installments aggregating (1) 1.250% of the original aggregate principal amount of the term loans during each of the first eight quarters following the closing, (2) 1.875% of the original aggregate principal amount of the term loans during each of the next four quarters following the closing, (3) 2.500% of the original aggregate principal amount of the term loans during each of the remaining quarters prior to maturity on June 8, 2017, at which time the entire unpaid principal balance of the term loans is due and payable.

The Fifth Amended Credit Agreement contains various financial covenants, which require us to maintain, as defined therein, ratios or levels of 1) total funded debt to EBITDA and 2) fixed charge coverage. The Fifth Amended Credit Agreement also limits the amount of dividends and repurchases of the Company’s common stock. As of September 30, 2012, we were in compliance with all of the covenant requirements of the Fifth Amended Credit Agreement.

In order to reduce our exposure to interest rate fluctuations on our floating rate debt commitments, we maintain interest rate swap agreements that effectively modify our exposure to interest rate risk by converting a portion of our floating rate debt to fixed obligations, thus reducing the impact of interest rate changes on future interest expense. Under these agreements, we receive a variable rate of interest based on LIBOR, and we pay a fixed rate of interest with interest rates ranging from 0.370% to 3.385% plus a spread. We maintain interest rate swap agreements with current notional amounts of $475.0 million and termination dates ranging from December 31, 2012 to December 31, 2016. Of this amount, $200.0 million will become effective in 2013, and $50.0 million in 2015, as older interest rate swap agreements expire. We have designated these interest rate swap agreements as qualifying cash flow hedges. We currently meet the hedge accounting criteria under U.S. GAAP in accounting for these interest rate swap agreements.

In October 2010, our Board of Directors authorized a share repurchase program, which allowed for the repurchase of up to $60 million of our common stock from time to time in the open market or in privately negotiated transactions through October 19, 2012. As of September 30, 2012, $31.8 million of our common stock was still subject to repurchase under this program. No shares were repurchased between October 1 and October 19, 2012 pursuant to the program.

We believe that cash flows from operating activities, our available cash, and our anticipated available credit under the Fifth Amended Credit Agreement will continue to enable us to meet our contractual obligations and to fund our current operations for the foreseeable future. However, if our operations require significant additional financing resources, such as capital expenditures for technology improvements, additional well-being improvement centers and/or letters of credit or other forms of financial assurance to guarantee our performance under the terms of new contracts, or if we are required to refund performance-based fees pursuant to contract terms, we may need to raise additional capital by expanding our existing credit facility and/or issuing debt or

equity. If we face a limited ability to arrange such financing, it may restrict our ability to effectively operate our business. We cannot assure you that we would always be able to secure additional financing if needed and, if such funds were available, whether the terms or conditions would be acceptable to us.

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

Recently Issued Accounting Standard

In July 2012, the FASB issued ASU No. 2012-02, "Intangibles—Goodwill and Other (Topic 350)—Testing Indefinite-Lived Intangible Assets for Impairment". ASU No. 2012-02 permits an entity to perform a qualitative assessment to determine whether it is more likely than not that the fair value of an indefinite-lived intangible asset is less than its carrying value. If the entity concludes that this is the case, it must perform the currently prescribed quantitative impairment test by comparing the fair value of the indefinite-lived intangible asset with its carrying value. Otherwise, the quantitative impairment test is not required. ASU No. 2012-02 is effective for fiscal years beginning after September 15, 2012, with earlier adoption permitted. We do not expect the adoption of this standard to have a material impact on our consolidated results of operations, financial position, cash flows, or notes to the consolidated financial statements.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

We are subject to market risk related to interest rate changes, primarily as a result of the Fifth Amended Credit Agreement. Borrowings under the Fifth Amended Credit Agreement generally bear interest at variable rates based on a margin or spread in excess of either (1) the one-month, two-month, three-month or six-month rate (or with the approval of affected lenders, nine-month or twelve-month rate) for Eurodollar deposits ("LIBOR") or (2) the greatest of (a) the prime lending rate, (b) the federal funds rate plus 0.50%, and (c) one-month LIBOR plus 1.00% (the "Base Rate"), as selected by the Company. The LIBOR margin varies between 1.75% and 3.00%, and the Base Rate margin varies between 0.75% and 2.00%.

In order to manage our interest rate exposure under the Fifth Amended Credit Agreement, we have entered into interest rate swap agreements effectively converting a portion of our floating rate debt to fixed obligations with interest rates ranging from 0.370% to 3.385% plus a spread.

A one-point interest rate change would have resulted in a change in interest expense of approximately $0.8 million for the nine months ended September 30, 2012.

As a result of our investment in international initiatives, we are also exposed to foreign currency exchange rate risks. Because a significant portion of these risks is economically hedged with currency options and forwards contracts and because our international initiatives are not yet material to our consolidated results of operations, a 10% change in foreign currency exchange rates would not have had a material impact on our consolidated results of operations, financial position, or cash flows for the nine months ended September 30, 2012. We do not execute transactions or hold derivative financial instruments for trading purposes.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Our chief executive officer and chief financial officer have reviewed and evaluated the effectiveness of our "disclosure controls and procedures" (as defined in Rule 13a-15(e) and 15d-15(e) promulgated under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of September 30, 2012. Based on that evaluation, the chief executive officer and chief financial officer have concluded that our disclosure controls and procedures are effective. They are designed to ensure that information required to be disclosed in the reports that the Company files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the U.S. Securities and Exchange Commission's rules and forms and to ensure that information required to be disclosed in the reports that the Company files or submits under the Exchange Act is accumulated and communicated to management, including our chief executive officer and chief financial officer, to allow timely decisions regarding required disclosure.

Changes in Internal Control over Financial Reporting

There have been no changes in our internal controls over financial reporting during the three months ended September 30, 2012 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Part II

Item 1.Legal Proceedings

Contract Dispute

We currently are involved in a contractual dispute with Blue Cross Blue Shield of Minnesota regarding fees paid to us as part of a former contractual relationship. On January 25, 2010, Blue Cross Blue Shield of Minnesota issued notice of arbitration with the American Arbitration Association in Minneapolis alleging a violation of certain contract provisions. We believe we performed our services in compliance with the terms of our agreement and that the assertions made in the arbitration notice are without merit. On August 3, 2011, we asserted numerous counterclaims against Blue Cross Blue Shield of Minnesota. We are not able to reasonably estimate a range of potential losses, if any.

Anti-Trust Lawsuit

On May 1, 2012, American Specialty Health Group (“ASH”) amended a claim (the “Amended Claim”) that it had previously filed against the Company in the U.S. District Court in the Southern District of California (“Court”) on December 2, 2011 (the “Original Claim”). The Original Claim alleged that the Company’s exclusivity provisions in some of its contracts with participating locations in its SilverSneakers fitness network violate California’s Unfair Competition Law (“UCL”) and that the Company interfered with ASH’s contractual relations and prospective economic advantages. The Amended Claim added allegations that the Company is in violation of the Sherman Antitrust Act (the “Act”) because such exclusivity provisions create illegal restraints on trade and constitute monopolization or attempted monopolization in violation of the Act. Under the Amended Claim, ASH is seeking damages in excess of $15,000,000, treble damages under the Act, and injunctive relief. The Company has asserted counterclaims against ASH for interference and violation of the UCL, and on October 12, 2012, the Court granted the Company’s motion to add an additional counterclaim that ASH has falsely advertised the composition of its fitness facility network in violation of the Lanham Act.

We believe ASH’s claims are without merit and intend to vigorously defend ourselves against the Amended Claim.

Performance Award Lawsuit

On September 4, 2012, Milton Pfeiffer (“Plaintiff”), claiming to be a stockholder of the Company, filed a putative derivative action against the Company and the Board of Directors in Delaware Chancery Court alleging that the Compensation Committee and the Board of Directors breached their fiduciary duties and violated the Company’s 2007 Stock Incentive Plan (the “Plan”) by granting Ben R. Leedle, Jr., Chief Executive Officer and President of the Company, a discretionary performance award under the Plan of 500,000 shares (the “Performance Award”), which consisted of 365,000 performance awards issued in November 2011 and 135,000 performance awards issued in February 2012. Plaintiff alleges that the Performance Award exceeded what is authorized by the Plan and that the Company’s 2012 proxy statement, in which the Performance Award is disclosed, is false and misleading. Plaintiff also alleges that Mr. Leedle breached his fiduciary duties and was unjustly enriched by receiving the Performance Award. Plaintiff is seeking, inter alia, the rescission or disgorgement of all alleged “excess” awards granted to Mr. Leedle under the Performance Award, to recover any incidental damages to the Company, and an award of attorneys’ fees and expenses. We believe Plaintiff’s claims are without merit and intend to vigorously defend ourselves against the action.

Outlook

We are also subject to other contractual disputes, claims and legal proceedings that arise from time to time in the ordinary course of our business. While we are unable to estimate a range of potential losses, we do not believe that any of the legal proceedings pending against us as of the date of this report will have a material adverse effect on our liquidity or financial condition. As these matters are subject to inherent uncertainties, our view of these matters may change in the future.

Item 1A. Risk Factors

In addition to the other information set forth in this report, you should carefully consider the risks and uncertainties previously reported under the caption "Part I — Item 1A. Risk Factors" in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011, the occurrence of which could materially and adversely affect our business, prospects, financial condition and operating results. The risks previously reported and described in the Annual Report on Form 10-K for the fiscal year ended December 31, 2011 and in this report are not the only risks facing our business. Additional risks and uncertainties not currently known to us or those we currently deem to be immaterial may also materially and adversely affect our business operations.

There have been no material changes to our risk factors previously disclosed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011.

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

The Company's Board of Directors authorized a share repurchase program, which was publicly announced on October 21, 2010. The share repurchase program allows for the repurchase of up to $60 million of our common stock from time to time in the open market or in privately negotiated transactions through October 19, 2012. No shares were repurchased between July 1, 2012 and September 30, 2012 pursuant to the program.

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs
July 1 through 31, 2012	—	—	2,254,953	$31,813,383
August 1 through 31, 2012	—	—	2,254,953	$31,813,383
September 1 through 30, 2012	—	—	2,254,953	$31,813,383
Total	—			

Item 3. Defaults Upon Senior Securities

Not Applicable.

Item 4. Mine Safety Disclosures

Not Applicable.

Item 5. Other Information

Not Applicable.

Item 6. Exhibits

(a) Exhibits

31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended
31.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended
32	Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema
101.CAL	XBRL Taxonomy Extension Calculation Linkbase
101.DEF	XBRL Taxonomy Extension Definition Linkbase
101.LAB	XBRL Taxonomy Extension Label Linkbase
101.PRE	XBRL Taxonomy Extension Presentation Linkbase

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 hereunto duly authorized.

Healthways, Inc.
(Registrant)

Date	November 8, 2012	By	/s/ Alfred Lumsdaine
			Alfred Lumsdaine
			Chief Financial Officer
			(Principal Financial Officer)