HMS HOLDINGS CORP
Form 10-Q
November 09, 2011
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2011

Or

o 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 000-50194

HMS HOLDINGS CORP.

(Exact name of registrant as specified in its charter)

New York	**11-3656261**
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
401 Park Avenue South, New York, NY	**10016**
(Address of principal executive offices)	(Zip Code)

(Registrant s Telephone Number, Including Area Code)

(212) 725-7965

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

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

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

Large accelerated filer x	Accelerated filer o
Non-accelerated filer o	Smaller reporting company o

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

As of November 2, 2011 there were approximately 85,054,077 shares of the registrant s common stock (par value $0.01 per share) outstanding.

Table of Contents

HMS HOLDINGS CORP. AND SUBSIDIARIES

QUARTERLY REPORT ON FORM 10-Q

FOR THE QUARTER ENDED SEPTEMBER 30, 2011

INDEX

Table of Contents

Special Note Regarding Forward-Looking Statements

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of the U.S. Private Securities Litigation Reform Act of 1995. From time to time, we also provide forward-looking statements in other materials we release to the public, as well as oral forward-looking statements. Such statements give our expectations or forecasts of future events; they do not relate strictly to historical or current facts.

We have tried, wherever possible, to identify such statements by using words such as anticipate, estimate, expect, project, intend, plan, believe, will, target, seek, forecast and similar expressions. In particular, these include statements relating to future actions, business plans, objects and prospects, future operating or financial performance or results of current and anticipated services, acquisitions and the performance of companies we have acquired, sales efforts, expenses, interest rates, and the outcome of contingencies, such as financial results.

We cannot guarantee that any forward-looking statement will be realized. Forward-looking statements are based on our current expectations and assumptions regarding our business, the economy and other future conditions. Should known or unknown risks or uncertainties materialize, or should underlying assumptions prove inaccurate, actual results could differ materially from past results and those anticipated, estimated or projected. We caution you, therefore, against relying on any of these forward-looking statements. They are neither statements of historical fact nor guarantees or assurances of future performance. Factors that could cause or contribute to such differences include, but are not limited to, those discussed in our Annual Report on Form 10-K, and in particular, the risks discussed under the heading Risk Factors in Part I, Item 1A of our Annual Report on Form 10-K, Part II of this 10-Q and those discussed in other documents we file with the Securities and Exchange Commission.

Any forward-looking statements made by us in this Report on Form 10-Q speak only as of the date on which they are made. Factors or events that could cause actual results to differ may emerge from time to time and it is not possible for us to predict all of them. We undertake no obligation to publicly update forward-looking statements, whether as a result of new information, future events or otherwise, except as may be required by law. You are advised, however, to consult any further disclosures we make on related subjects in our 10-K and 8-K reports to the Securities and Exchange Commission.

Table of Contents

HMS HOLDINGS CORP. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(in thousands, except share and per share amounts)

(unaudited)

	September 30, 2011	December 31, 2010
Assets		
Current assets:		
Cash and cash equivalents	$ 140,451	$ 94,836
Accounts receivable, net of allowance of $650 at September 30, 2011 and $799 at December 31, 2010	83,483	75,123
Prepaid expenses	6,360	5,521
Prepaid income taxes		3,533
Other current assets	5,407	371
Net deferred tax asset	796	664
Total current assets	236,497	180,048
Property and equipment, net	46,561	44,713
Goodwill, net	107,026	107,414
Intangible assets, net	16,136	19,826
Other assets	847	904
Accounts receivable, long term	2,160	
Total assets	$ 409,227	$ 352,905
Liabilities and Shareholders Equity		
Current liabilities:		
Accounts payable, accrued expenses and other liabilities	$ 28,421	$ 32,502
Contingent payables	3,315	
Total current liabilities	31,736	32,502
Long-term liabilities:		
Contingent payables		2,573
Deferred rent	1,419	1,842
Other liabilities	2,221	2,582
Deferred tax liabilities	7,408	5,768
Total long-term liabilities	11,048	12,765
Total liabilities	42,784	45,267
Shareholders equity:		
Preferred stock - $0.01 par value; 5,000,000 shares authorized; none issued		
Common Stock - $0.01 par value; 125,000,000 shares authorized; 89,961,818 shares issued and 84,973,280 shares outstanding at September 30, 2011; 88,341,546 shares issued and 83,353,008 shares outstanding at December 31, 2010	900	883
Capital in excess of par value	226,584	204,450
Retained earnings	148,356	111,702
Treasury stock, at cost; 4,988,538 shares at September 30, 2011 and December 31, 2010	(9,397)	(9,397)
Total shareholders equity	366,443	307,638
Total liabilities and shareholders equity	$ 409,227	$ 352,905

See accompanying notes to unaudited consolidated financial statements.

Table of Contents

HMS HOLDINGS CORP. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

(in thousands, except per share amounts)

(unaudited)

	Three months ended September 30, 2011	Three months ended September 30, 2010	Nine months ended September 30, 2011	Nine months ended September 30, 2010
Revenue	$ 92,356	$ 80,022	$ 264,159	$ 215,700
Cost of services:				
Compensation	31,762	27,211	94,604	76,391
Data processing	5,973	4,576	16,607	12,691
Occupancy	3,794	3,490	11,328	9,640
Direct project costs	9,893	9,818	30,546	25,596
Other operating costs	4,637	4,565	13,448	11,738
Amortization of acquisition related software and intangibles	1,660	1,665	5,048	4,566
Total cost of services	57,719	51,325	171,581	140,622
Selling, general and administrative expenses	10,560	10,419	31,932	28,899
Total operating expenses	68,279	61,744	203,513	169,521
Operating income	24,077	18,278	60,646	46,179
Interest expense	(19)	(24)	(65)	(70)
Other income, net	165	(31)	714	(31)
Interest income	14	32	50	73
Income before income taxes	24,237	18,255	61,345	46,151
Income taxes	9,822	7,209	24,691	18,414
Net income	$ 14,415	$ 11,046	$ 36,654	$ 27,737
Basic income per common share				
Net income per share basic	$ 0.17	$ 0.13	$ 0.43	$ 0.34
Diluted income per share				
Net income per share diluted	$ 0.17	$ 0.13	$ 0.42	$ 0.33
Weighted average shares:				
Basic	84,159	82,009	84,372	81,367
Diluted	86,869	85,450	87,233	85,040

See accompanying notes to unaudited consolidated financial statements.

Table of Contents

HMS HOLDINGS CORP. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY AND COMPREHENSIVE INCOME

For the Nine Months Ended September 30, 2011

(in thousands, except share amounts)

(unaudited)

	Common stock		Capital in		Treasury Stock		Total
	# of Shares Issued	Par Value	Excess of Par Value	Retained Earnings	# of Shares	Amount	Shareholders Equity
Balance at December 31, 2010	88,341,546	$ 883	$ 204,450	111,702	4,988,538	$ (9,397)	$ 307,638
Comprehensive income:							
Net income				36,654			36,654
Total comprehensive income							36,654
Stock-based compensation cost			5,884				5,884
Exercise of Stock Options	1,541,069	17	8,996				9,013
Vesting of restricted stock awards and units, net of shares withheld for employee tax	79,203		(903)				(903)
Excess tax benefit from exercise of stock options			8,157				8,157
Balance at September 30, 2011	89,961,818	$ 900	$ 226,584	$ 148,356	4,988,538	$ (9,397)	$ 366,443

See accompanying notes to unaudited consolidated financial statements.

Table of Contents

HMS HOLDINGS CORP. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CASH FLOWS

(in thousands)

(unaudited)

	Nine months ended September 30, 2011	2010
Operating activities:		
Net income	$ 36,654	$ 27,737
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	14,930	11,478
Stock-based compensation expense	5,884	5,334
Deferred income taxes	1,508	546
Decrease in allowance for doubtful debts	(149)	464
Change in fair value of contingent consideration	391	
Loss on disposal of fixed assets	5	22
Changes in assets and liabilities:		
Increase in accounts receivable	(10,371)	(10,020)
(Increase)/Decrease in prepaid expenses	(839)	544
(Increase)/Decrease in prepaid income taxes	3,533	(1,612)
Increase in other current assets	(388)	(70)
Decrease in other assets	57	685
Decrease in accounts payable, accrued expenses and other liabilities	(2,125)	(43)
Net cash provided by operating activities	49,090	35,065
Investing activities:		
Investment in certificate of deposit	(4,809)	
Purchases of property and equipment	(13,092)	(10,488)
Purchase of building and land		(9,886)
Acquisition of AMG-SIU	161	(12,795)
Acquisition of Verify Solutions	(500)	
Acquisition of Chapman Kelly		(13,001)
Investment in capitalized software	(1,502)	(1,512)
Net cash used in investing activities	(19,742)	(47,682)
Financing activities:		
Proceeds from exercise of stock options	9,013	5,486
Payments of tax withholdings on behalf of employees for net-share settlement for stock-based compensation	(903)	
Excess tax benefit from exercised stock options	8,157	8,303
Net cash provided by financing activities	16,267	13,789
Net increase in cash and cash equivalents	45,615	1,172
Cash and cash equivalents at beginning of period	94,836	64,863
Cash and cash equivalents at end of period	$ 140,451	$ 66,035
Supplemental disclosure of cash flow information:		
Cash paid for income taxes	$ 11,547	$ 11,269
Cash paid for interest	$ 89	$ 46
Supplemental disclosure of noncash investing activities:		
Accrued property and equipment purchases	$ 438	$ 674
Accrued acquisition related contingent consideration	$ 351	$ 2,573

See accompanying notes to unaudited consolidated financial statements.

Table of Contents

HMS HOLDINGS CORP. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

For the Three and Nine Months Ended September 30, 2011 and 2010

(unaudited)

1. Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. Generally Accepted Accounting Principles, or U.S. GAAP, for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by U.S. GAAP for complete financial statements. In the opinion of management, the unaudited interim financial statements furnished herein include all adjustments necessary (consisting only of normal recurring adjustments) for a fair presentation of our and our subsidiaries financial position at September 30, 2011, the results of our operations for the three and nine months ended September 30, 2011 and 2010 and cash flows for the nine months ended September 30, 2011 and 2010. Interim financial statements are prepared on a basis consistent with our annual financial statements. The financial statements included herein should be read in conjunction with the financial statements and notes included in our Annual Report on Form 10-K for the year ended December 31, 2010, which we refer to as our Annual Report.

We provide a variety of cost containment, coordination of benefits and program integrity services for government and private healthcare payors and sponsors. These services are designed to help our clients recover amounts due from liable third parties, save dollars, reduce fraud, waste and abuse and ensure regulatory compliance. In September 2008, we purchased the assets and liabilities of Prudent Rx, expanding our portfolio of program integrity service offerings for government healthcare programs and managed care organizations, particularly in the pharmacy arena. In September 2009, we further expanded our portfolio of program integrity service offerings for government healthcare programs, particularly in the Medicare and Medicaid programs with our acquisition of IntegriGuard LLC, or IntegriGuard. In December 2009, with the acquisition of Verify Solutions, Inc., or Verify Solutions, we moved into the employer-based market with valuable new services that ensure that dependents covered by employees are eligible to receive healthcare benefits. In June 2010, we acquired Allied Management Group Special Investigation Unit, or AMG-SIU, which provides fraud, waste and abuse prevention and detection solutions for healthcare payors. In August 2010, we acquired Chapman Kelly, Inc., or Chapman Kelly, which provides claims audit and beneficiary eligibility audit services to employers and managed care organizations.

These consolidated financial statements include our accounts and transactions and those of our wholly owned subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation.

We are managed and operated as one business, with a single management team that reports to the Chief Executive Officer. We do not operate separate lines of business with respect to any of our product lines.

The preparation of financial statements in conformity with U.S. GAAP requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting periods. Our actual results could differ from those estimates.

We consider all highly liquid instruments with an original maturity of three months or less to be cash equivalents. Cash equivalents consist of deposits that are readily convertible into cash.

Our financial instruments are categorized into a three-level fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The fair value hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). If the inputs used to measure fair value fall within different levels of the hierarchy, the category level is based on the lowest priority level input that is significant to the fair value measurement of the instrument. Financial assets recorded at fair value on our consolidated balance sheets are categorized as follows:

- Level 1: Observable inputs such as quoted prices in active markets;
- Level 2: Inputs, other than the quoted prices in active markets, that are observable either directly or indirectly; and
- Level 3: Unobservable inputs in which there is little or no market data, which require the reporting entity to develop its own assumptions.

Table of Contents

Our policy is to limit our credit exposure by placing our investments with financial institutions evaluated as being creditworthy, or in short-term money market funds which are exposed to minimal interest rate and credit risk. We maintain our cash primarily in investment accounts and certificate of deposits within large financial institutions. The balances in these accounts may exceed the maximum balance insured by the Federal Deposit Insurance Corporation up to $250,000 per bank account. We have not experienced any losses on our bank deposits and we believe these deposits do not expose us to any significant credit risk.

We are subject to potential credit risk related to changes in economic conditions within the healthcare market. However, we believe that our billing and collection policies are adequate to minimize the potential credit risk.

We evaluate the recoverability of goodwill and long-lived assets either annually or whenever events or changes in circumstances indicate that an asset s carrying amount may not be recoverable. Such circumstances could include, but are not limited to (i) a significant decrease in the market value of an asset, (ii) a significant adverse change in the extent or manner in which an asset is used, or (iii) an accumulation of costs significantly in excess of the amount originally expected for the acquisition of an asset. We measure the carrying amount of the asset against the estimated undiscounted future cash flows associated with it. If the sum of the expected future net cash flows is less than the carrying value of the asset being evaluated, an impairment charge would be recognized. The impairment charge would be calculated as the amount by which the carrying value of the asset exceeds its fair value. The determination of fair value is based on quoted market prices, if available. If quoted market prices are not available, the estimate of fair value is based on various valuation techniques, including the discounted value of estimated future cash flows. We did not recognize any impairment charges related to our long-lived assets, property and equipment, goodwill or intangible assets, during the nine months ended September 30, 2011 and 2010, as management believes that carrying amounts were not impaired.

The carrying amounts for our cash equivalents, accounts receivable, accounts payable and accrued expenses approximate fair value due to their short-term nature.

In April 2011, our Board of Directors approved a three-for-one stock split of our outstanding shares of common stock. In July 2011, at our annual shareholders meeting, our shareholders approved an increase in our authorized common stock, which was necessary in order to effect the stock split. The stock split was subsequently effected in the form of a stock dividend of two additional common shares for each share owned by shareholders of record at the close of business on July 22, 2011 and was paid on August 16, 2011. All common share and per share information in our consolidated financial statements have been revised retroactively to reflect the stock split.

Certain reclassifications were made to prior year amounts to conform to the current presentation. These reclassifications had no impact on previously reported net income or financial position. This includes reclassifications of certain expenses from cost of services to selling, general and administration expenses.

Recently Issued Accounting Pronouncements

In December 2010, the Financial Accounting Standards Board, or FASB, issued authoritative accounting guidance on the disclosure of supplementary pro forma information for business combinations to clarify the reporting of pro forma financial information related to business combinations of public entities and expand certain supplemental pro forma disclosures. This guidance is effective prospectively for business combinations that occur on or after the beginning of the fiscal year beginning on or after December 15, 2010, with early adoption permitted. We do not expect that this guidance will have a material effect on our consolidated financial statements.

In May 2011, FASB issued authoritative accounting guidance for updates on Fair Value Measurements, specifically, Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and International Financial Reporting Standards. This update amends Accounting Standards Codification (ASC) Topic 820, Fair Value Measurement and Disclosure, clarifies the application of certain existing fair value measurement guidance and expands the disclosures for fair value measurements that are estimated using significant unobservable (Level 3) inputs. This authoritative guidance is effective for annual and interim reporting periods beginning on or after December 15, 2011. This new guidance is to be adopted prospectively and early adoption is not permitted. We do not believe that adoption of this guidance will have a material effect on our consolidated financial statements.

In June 2011, FASB issued Accounting Standards Update (ASU) No. 2011-05 for the presentation of comprehensive income thereby amending Accounting Standards Codification (ASC) 220, *Comprehensive Income.* The amendments require that all non-owner changes in stockholder s equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The amendments are effective in fiscal years beginning after December 15, 2011 and should be applied retrospectively. These amendments will impact the presentation of our financial statements upon adoption.

Table of Contents

The FASB issued ASU No. 2011-08, Testing Goodwill for Impairment (the revised standard) in September 2011. Under the amendments in this ASU, an entity has an option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If, after assessing the totality of events or circumstances, an entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step impairment test is unnecessary. This ASU is effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. Early adoption is permitted. We do not believe that adoption of this guidance will have a material effect on our consolidated financial statements.

Excluding the recently issued authoritative accounting guidance noted above, there have been no developments to recently issued accounting standards, including the expected dates of adoption and estimated effects on our consolidated financial statements, from those disclosed in the our Annual Report on Form 10-K for the year ended December 31, 2010.

2. Acquisitions

The results of operations for our 2010 acquisitions have been included in our consolidated financial statements from the date of acquisition. We have concluded that these acquisitions were not material to our financial statements; therefore, pro forma financial information is not presented herein.

Chapman Kelly, Inc.

In August 2010, we acquired the assets and liabilities of Chapman Kelly for $13.0 million in cash. Chapman Kelly, which is based in Jeffersonville, Indiana, provides dependent eligibility audits to large, self-insured employers, as well as plan and claims audits to both employers and managed care organizations. The acquisition of Chapman Kelly was accounted for under the acquisition method of accounting.

During the first quarter of 2011, we finalized the purchase price allocation which resulted in an increase to customer relationships of $739 thousand and an offsetting decrease to goodwill as compared to the amounts recorded at December 31, 2010.

Allied Management Group - Special Investigation Unit

In June 2010, we purchased all of the issued and outstanding common stock of AMG-SIU for a purchase price valued at $15.1 million, consisting of a $13.0 million initial cash payment (subsequently reduced by a working capital reduction of $0.2 million) and future contingent payments estimated and recognized as of the acquisition date at $2.3 million. The purchase price included $3.5 million due to the seller in three annual payments: $1.8 million in September 2011 and $875,000 in September 2012 and 2013, of which the $1.8 million for 2011 has been paid. The future contingent payments are based on AMG-SIU s financial performance for each of the twelve month periods ending June 30, 2011 and June 30, 2012 and are not subject to any cap. We did not make the 2011 contingent payment as AMG-SIU did not achieve the required financial milestone. Any contingent payment owed for the period ending June 30, 2012 is to be payable by September 30, 2012. The undiscounted 2012 contingent payment is currently estimated to be $3.4 million. AMG-SIU, which is based in Santa Ana, California, specializes in fraud, waste and abuse prevention and detection solutions for healthcare payors, which further strengthens our ability to service this segment of the market. The acquisition of AMG-SIU was accounted for under the acquisition method of accounting.

The fair value of the contingent consideration recognized on the acquisition date of June 30, 2010 was estimated by applying the income approach. The measure is based on significant inputs not observable in the market that are defined by the FASB, guidance on fair value as Level 3 inputs. We are obligated to make contingent payments subject to satisfaction of certain financial results of AMG-SIU as discussed in stock purchase agreement. As of September 30, 2011 and December 31, 2010, the fair value of the contingent payment was $3.0 million and $2.6 million, respectively.

Verify Solutions, LLC

In December 2009, we acquired the assets of Verify Solutions, an Alpharetta, Georgia-based company specializing in dependent eligibility audit services for large, self insured employers. With this acquisition, we moved into the large and mid-market employer-based market.

Table of Contents

The purchase price for Verify Solutions was $8.1 million. The purchase price includes an additional $148,000 working capital payment made in 2010 and $500,000 initially not due to the seller until 2011, which has been paid. Verify Solutions did not meet the 2010 financial performance milestones and as such did not earn the related milestone payment.

In December 2010, following our acquisition of Chapman Kelly, which together with Verify Solutions forms HMS Employer Solutions, we amended the terms of the contingent payment for 2011. Under the terms of this amendment, the former owners of Verify Solutions could earn a contingent payment of between $1.3 million and $2.8 million based on the revenue generated by HMS Employer Solutions for the year ending December 31, 2011. If earned, the contingent payment will be accrued and recorded to compensation expense in 2011. It has been determined that the conditions to earn the 2011 contingent payment will not be achieved, accordingly no amounts have been accrued.

3. Intangible Assets

Intangible assets consisted of the following at September 30, 2011 and December 31, 2010

(in thousands):

		September 30, 2011		December 31, 2010	Useful Life
Customer relations	$	32,987	$	32,247	5-10 years
Trade name		3,932		3,932	3-7 years
Restrictive covenant		2,626		2,626	3-5 years
		39,545		38,805	
Less accumulated amortization		(23,409)		(18,979)	
Intangible assets, net	$	16,136	$	19,826	

Estimated amortization expense for intangible assets is expected to approximate the following (in thousands):

Year Ending December 31,		
Remainder of 2011	$	1,460
2012		5,816
2013		4,263
2014		1,320
2015		994
Thereafter		2,283

The changes in the carrying amount of goodwill for the nine months ended September 30, 2011 are as follows (in thousands):

Balance at December 31, 2010	$	107,414

Chapman Kelly acquisition measurement period adjustments		(739)
Prudent Rx earnout		351
Balance at September 30, 2011	$	107,026

For the three and nine months ended September 30, 2011, amortization expense related to intangible assets amounted to $1.5 million and $4.4 million, respectively. For the three and nine months ended September 30, 2010, amortization expense related to intangible assets amounted to $1.5 million and $4.0 million, respectively.

Table of Contents

4. Income Taxes

Our effective tax rate increased to 40.5% for the three months ended September 30, 2011 from 39.5% for the three months ended September 30, 2010, primarily due to a change in state apportionments and permanent differences. The principal difference between the statutory rate and our effective rate is state taxes.

Our effective tax rate increased to 40.3% for the nine months ended September 30, 2011 from 39.9% for the nine months ended September 30, 2010, primarily due to a change in state apportionments and permanent differences. The principal difference between the statutory rate and our effective rate is state taxes.

We file income tax returns with the U.S. federal government and various state jurisdictions. We are no longer subject to U.S. federal income tax examinations for years before 2008. We operate in a number of state and local jurisdictions, most of which have never audited our records. Accordingly, we are subject to state and local income tax examinations based upon the various statutes of limitations in each jurisdiction.

During the nine months ended September 30, 2011 and 2010, we recorded a tax benefit of $8.2 million and $8.3 million, respectively, related to the utilization of the income tax benefit from stock transactions by reducing income tax payable and crediting capital.

At September 30, 2011 and 2010, we had approximately $1.3 million and $1.3 million of net unrecognized tax benefits, respectively, for which there is uncertainty about the allocation and apportionment impacting state taxable income. We do not expect any significant change in unrecognized tax benefits during the next twelve months. We have recognized interest accrued related to unrecognized tax benefits in interest expense and penalties in tax expense. The accrued liabilities related to uncertain tax positions were $0.5 million for each of the nine month periods ending September 30, 2011 and 2010.

We believe that it is reasonably possible that decreases in unrecognized tax benefits of up to $70,000 may be recorded within the next year.

5. Debt

We had a credit agreement with several banks and other financial institutions, with JPMorgan Chase Bank, N.A. (JPMCB) as administrative agent, that expired in September of 2011. The agreement provided for a term loan of $40.0 million and revolving credit loans of up to $25.0 million.

In June 2011, we purchased a certificate of deposit in the amount of $4.8 million to collateralize an existing irrevocable standby Letter of Credit that we entered into as part of our contractual agreement with a client. The certificate of deposit is included within other current assets on our balance sheet.

6. Earnings Per Share

Basic income per share is calculated by dividing net income by the weighted average number of common shares outstanding during the period. Diluted income per share is calculated by dividing net income by the weighted average number of common shares and dilutive common share equivalents outstanding during the period. Our common share equivalents consist of stock options and restricted stock awards and units.

The following table reconciles the basic to diluted weighted average shares outstanding using the treasury stock method (shares in thousands):

	Three months ended September 30,		**Nine months ended September 30,**	
	2011	**2010**	**2011**	**2010**
Weighted average shares outstanding basic	84,159	82,009	84,372	81,367
Dilutive effect of stock options	2,579	3,324	2,721	3,565
Dilutive effect of restricted stock awards and units	131	117	140	108
Weighted average shares outstanding - diluted	86,869	85,450	87,233	85,040

Table of Contents

For the three months ended September 30, 2011 and 2010, 210,776 and 37,137 stock options, respectively, were not included in the diluted earnings per share calculation because the effect would have been anti-dilutive.

For the nine months ended September 30, 2011 and 2010, 206,649 and 33,981 stock options, respectively, were not included in the diluted earnings per share calculation because the effect would have been anti-dilutive. For the nine months ended September 30, 2011 and 2010, restricted stock units representing 41,574 and 1,506 shares of common stock, respectively, were not included in the diluted earnings per share calculation because the effect would have been anti-dilutive.

We issue restricted stock units under the terms of our 2006 Stock Plan, as amended, or the 2006 Stock Plan. For the majority of restricted stock units granted, the number of shares issued on the date the restricted stock units vest is net of the statutory withholding requirements that we pay on behalf of our employees. During 2011, net restricted stock awards and restricted stock units of 79,203 were vested after the withholding of 37,158 shares to satisfy $0.9 million of employees tax obligations. Although shares withheld are not issued, they are treated as common stock repurchases for accounting and disclosure purposes, as they reduce the number of shares that would have been issued upon vesting.

7. Stock-Based Compensation

Total stock-based compensation expense charged as a selling, general and administrative expense in our consolidated statements of income related to our stock compensation plans was $1.9 million and $1.9 million for the three months ended September 30, 2011 and September 30, 2010, respectively, and $5.9 million and $5.3 million for the nine months ended September 30, 2011 and September 30, 2010, respectively.

The total income tax benefit related to stock-based compensation expense recognized in our consolidated statements of income was $0.8 million and $0.8 million, for the three months ended September 30, 2011 and 2010, respectively, and $2.3 million and $2.1 million, for the nine months ended September 30, 2011 and 2010, respectively.

Presented below is a summary of our stock option activity for the nine months ended September 30, 2011 (shares in thousands):

	Shares		Weighted Average Exercise Price	Weighted Average Remaining Contractual Terms		Aggregate Intrinsic Value
Outstanding at						
December 31, 2010	6,969	$	8.07			
Granted	14	$	22.39			
Exercised	(1,541)	$	5.85			
Forfeitures	(48)	$	14.12			
Expired						
Outstanding at September 30, 2011	5,394	$	8.66	4.09	$	86,712
Expected to vest at September 30, 2011	2,436	$	12.45	4.71	$	29,092

Exercisable at September 30, 2011	2,883	$ 5.41	3.51	$	54,707

The fair value of each option grant was estimated using the Black-Scholes option pricing model. Expected volatilities are calculated based on the historical volatility of our common stock. Management monitors share option exercise and employee termination patterns to estimate forfeiture rates within the valuation model. Separate groups of employees that have similar historical exercise behavior are considered separately for valuation purposes. The expected holding period of options represents the period of time that options granted are expected to be outstanding. The expected terms of options granted are based upon our historical experience for similar types of stock option awards. The risk-free interest rate is based on U.S. Treasury notes.

We estimated the fair value of each stock option grant on the date of the grant using a Black-Scholes option-pricing model and the weighted-average assumptions set forth in the following table:

	Nine months ended September 30,	
	2011	**2010**
Expected dividend yield	0%	0%
Risk-free interest rate	3.04%	2.47%
Expected volatility	43.7%	43.8%
Expected life	4.0 years	4.0 years

During the three months ended September 30, 2011 and 2010, we issued 0.3 million shares, and 0.8 million shares, respectively, of our common stock upon the exercise of outstanding stock options and received proceeds of $1.3 million, and $1.8 million, respectively. For the three months ended September 30, 2011 and 2010, we realized a $1.2 million and $3.3 million tax benefit from the exercise of stock options, respectively.

For the nine months ended September 30, 2011 and 2010, we issued 1.5 million shares, and 1.8 million shares, respectively, of our common stock upon the exercise of outstanding stock options and received proceeds of $9.0 million, and $5.5 million, respectively. For the nine months ended September 30, 2011 and 2010, we realized an $8.2 million and $8.3 million tax benefit from the exercise of stock options, respectively.

For the three months ended September 30, 2011, and 2010, $1.2 million, and $1.6 million, respectively, of stock-based compensation cost relating to stock options has been charged against income. For the nine months ended September 30, 2011, and 2010, $3.7 million, and $4.5 million, respectively, of stock-based compensation cost relating to stock options has been charged against income. As of September 30, 2011, there was $5.6 million of total unrecognized compensation cost, adjusted for estimated forfeitures, related to stock options outstanding, which is expected to be recognized over a weighted-average period of 0.8 year.

The aggregate intrinsic value in the previous table reflects the total pretax intrinsic value (the difference between our closing stock price on the last trading day of the period and the exercise price of the options, multiplied by the number of in-the-money stock options) that would have been received by the option holders had all option holders exercised their options on September 30, 2011. The intrinsic value of our stock options changes based on the closing price of our common stock. The total intrinsic value of options exercised (the difference in the market price of our common stock on the exercise date and the price paid by the optionee to exercise the option) for the three months ended September 30, 2011 and 2010 was approximately $5.6 million and $10.2 million, respectively. The total intrinsic value of options exercised during the nine month periods ended September 30, 2011 and 2010 was $28.8 million and $24.4 million, respectively.

Restricted Stock Units

In February 2011, October 2010 and October 2009, certain employees received restricted stock units under the Third Amended and Restated 2006 Stock Plan, or the 2006 Stock Plan. In October 2010, our Board or Directors also received restricted stock units under the 2006 Stock Plan. The fair value of restricted stock units is estimated based on the closing sale price of our common stock on the NASDAQ Global Select Market on the date of issuance. The total number of restricted stock units expected to vest is adjusted by estimated forfeiture rates.

For the three months ended September 30, 2011, we granted 690 restricted stock units, with an aggregate fair market value of $16,849. For the nine months ended September 30, 2011, we granted 202,887 restricted stock units, with an aggregate fair market value of $5.0 million. At September 30, 2011, 342,069 restricted stock units remained unvested and there was $5.6 million of unamortized compensation cost related to restricted stock units, which is expected to be recognized over the remaining weighted-average vesting period of 2.3 years. Stock-based compensation expense related to restricted stock units was $0.6 million and $0.1 million for the three months ended September 30, 2011 and 2010, respectively and $1.5 million and $0.2 million for the nine months ended September 30, 2011 and 2010, respectively.

A summary of the status of our restricted stock units as of September 30, 2011 and of changes in restricted stock units outstanding under the 2006 Stock Plan for the nine months ended September 30, 2011 is as follows (in thousands, except for weighted average grant date fair value per unit):

	Number of Units		Weighted Average Grant Date Fair Value per Unit	Aggregate Intrinsic Value
Outstanding balance at December 31, 2010	171	$	17.15	
Granted	203	$	24.65	
Vesting of Restricted Units	(6)	$	19.65	
Cancelled	(7)	$	18.65	
Outstanding balance at September 30, 2011	361	$	21.35	8,717,912

Table of Contents

Restricted Stock Awards

Our executive officers have received grants of restricted stock awards under the 2006 Stock Plan. The vesting of restricted stock awards is subject to the executive officers continued employment with us. Recipients of restricted stock awards are not required to provide us with any consideration other than rendering service. Holders of restricted stock are permitted to vote and to receive dividends.

The stock-based compensation expense for restricted stock awards is determined based on the closing market price of our common stock on the grant date of the awards applied to the total number of awards that are anticipated to fully vest. Upon the vesting of the restricted stock awards, shares withheld to pay taxes are retired. We did not issue restricted stock awards during the nine months ended September 30, 2011. At September 30, 2011 approximately 287,820 shares underlying restricted stock awards remained unvested and there was approximately $1.8 million of unrecognized compensation cost related to restricted stock awards, which is expected to be recognized over the weighted-average period of 1.4 years. Stock-based compensation expense related to restricted stock awards $0.2 million for the three months ended September 30, 2011 and 2010, and $0.6 million for the nine months ended September 30, 2011 and 2010.

A summary of the status of our restricted stock awards at September 30, 2011 and of changes in restricted stock awards outstanding under the 2006 Stock Plan for the nine months ended September 30, 2011 is as follows (in thousands, except for weighted average grant date fair value):

	Shares	Weighted Average Grant Date Fair Value per Share	Aggregate Intrinsic Value
Outstanding balance at December 31, 2010	384	$ 10.42	
Granted			
Vesting of Restricted Awards	(63)	$ 10.42	
Shares withheld for payment of taxes upon vesting of restricted stock awards	(33)	$ 10.42	
Outstanding balance at September 30, 2011	288	$ 10.42	$ 7,020

The total fair value of restricted stock awards vested during the nine months ended September 30, 2011 was $1.0 million.

8. Subsequent Events

The Compensation Committee of the Board of Directors approved the October 3, 2011 grant of 853,845 stock option awards and 116,197 restricted stock units to employees and directors. The fair value calculated for stock options and restricted stock units which vest over a range of 1 to 3.25 years was $7.1 million and $2.7 million respectively.

On November 7, 2011, we entered into an Agreement and Plan of Merger, or the Merger Agreement, pursuant to which, and subject to the conditions thereof, upon the closing of the transactions contemplated thereby, HDI Holdings Inc., or HDI, will become our wholly owned subsidiary. We currently expect the closing to occur before the end of calendar year 2011. The consummation of this transaction is subject to the satisfaction or waiver of customary conditions, as set forth in the Merger Agreement and the receipt of domestic regulatory approvals.

Subject to the terms and conditions of the Merger Agreement, upon the closing, we will pay to the holders of HDI s capital stock and to the holders of options to purchase shares of HDI s capital stock (to the extent that all or any portion of such options are vested under and issuable upon exercise of such options as of immediately prior to the Closing) a total of $400 million less certain transaction expenses (the Consideration). The Consideration will consist of $384 million in cash, approximately $37 million of which will be immediately applied towards the repayment of certain indebtedness of HDI, and an additional $16 million which will be attributed to the assumption of then unvested options. A portion of the cash component of the Consideration will consist of funds from the proceeds of a $350 million bank term loan facility that we plan to enter into at the time of Closing.

HDI is a technology-enabled healthcare services company that identifies and recoups improper payments to hospitals, physicians, pharmacy, Durable Medical Equipment and other providers. HDI reviewed more than $300 billion in paid claims in the last year, applying rules approved by CMS and commercial health plan clients to identify fraud, waste and abuse. HDI is the exclusive Medicare Recovery Audit Contractor (RAC) for 17 states and three U.S. territories (Region D), covering approximately 25% of all Medicare claims in the nation.

In connection with the preparation of these Consolidated Financial Statements, an evaluation of subsequent events was performed through the date these Consolidated Financial Statements were issued and there are no other events that have occurred that would require adjustments or disclosure to our Consolidated Financial Statements.

Table of Contents

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

We begin Management s Discussion and Analysis of Financial Condition and Results of Operations with a discussion of the critical accounting policies that we believe are important to understanding the assumptions and judgments incorporated in our reported financial results. We then present a business overview followed by a discussion of our results of operations. Lastly, we provide an analysis of our liquidity and capital resources, including discussions of our cash flows, sources of capital and financial commitments.

The following discussions and analysis of financial condition and results of operations should be read in conjunction with the other sections of the Annual Report, including the Consolidated Financial Statements and Supplemental Data thereto appearing in Part II, Item 8 of the Annual Report, the Risk Factors appearing in Part I, Item 1A of the Annual Report and the disclaimer regarding forward-looking statements appearing at the beginning of Part I, Item 1 of the Annual Report. Historical results set forth in Part II, Item 6, Item 7 and Item 8 of the Annual Report should not be taken as necessarily indicative of our future operations.

Critical Accounting Policies

Since the date of our Annual Report on Form 10-K for the year ended December 31, 2010, there have been no material changes to our critical accounting policies.

General Overview

We provide a variety of cost containment services, including coordination of benefits and program integrity services, for government and private healthcare payors and sponsors. These services are designed to help our clients recover amounts due from liable third parties, save dollars, reduce fraud, waste and abuse and ensure regulatory compliance.

Our clients are state Medicaid agencies, Medicaid and Medicare managed care plans, government and private self-funded employers, Pharmacy Benefit Managers, or PBMs, child support agencies, the Veterans Health Administration, or VHA, the Centers for Medicare & Medicaid Services, or CMS, commercial plans, other healthcare payors and large business outsourcing and technology firms. We help these entities contain healthcare costs by ensuring that claims are paid correctly, through our program integrity services and by ensuring that claims are paid by the responsible party, through our coordination of benefits services.

In September 2010, we acquired privately-held Chapman Kelly, Inc., or Chapman Kelly, based in Jeffersonville, Indiana. Chapman Kelly provides dependent eligibility audits to large, self-insured employers, as well as plan and claims audits to employers and managed care organizations. With our acquisition of Chapman Kelly we have developed a robust Employer Solutions product area that provides dependent eligibility audit services to employers of all sizes and also augments our claim audit offering for healthcare plans.

In June 2010, we acquired privately-held Allied Management Group Special Investigation Unit, or AMG-SIU, a leading provider of fraud, waste and abuse prevention and detection solutions for healthcare payors. Based in Santa Ana, California, AMG-SIU provides audit and consulting services to both government and commercial healthcare payors and offers a proprietary forensic claim editing system to analyze claim data for patterns of fraud, waste and abuse. AMG-SIU employs an in-house special investigation unit to conduct preliminary research, investigations, medical record reviews and pharmacy reviews.

At September 30, 2011, we had cash and cash equivalents of $140.4 million, and net working capital of $204.7 million.Our revenue, most of which is derived from contingency fees, has increased at an average compounded rate of approximately 38.2% per year for the last five years. Our growth has been attributable to our expansion of existing product offerings and acquisitions, as well as an overall increase in Medicaid costs, which has historically averaged approximately 8% annually. In addition, state governments have increased their use of vendors for the coordination of benefits and other cost containment functions, and we have been able to increase our revenue through these initiatives. Leveraging our work on behalf of state Medicaid fee-for-service programs, we have penetrated the Medicaid managed care market, into which more Medicaid lives are being shifted. In addition to acting as a subcontractor for certain business outsourcing and technology firms, as of September 30, 2011, we served the District of Columbia and 43 state Medicaid programs, and 132 Medicaid health plans under an aggregate of 62 contracts.

To date, we have grown our business through the internal development of new services and through acquisitions of businesses whose core services strengthen our overall mission to help our clients control healthcare costs. In addition, we leverage our expertise to acquire new clients at the state, federal and employer levels and to expand our current contracts to provide new services to current clients. We are continuously evaluating opportunities that will enable us to expand the breadth of the services we provide and will consider acquisition opportunities that enable us to continue to grow our business to address the increasing needs of the healthcare industry in the post-healthcare reform era.

Table of Contents

In March 2010, the Patient Protection and Affordable Care Act, or the Affordable Care Act, was signed into law. According to Centers for Medicare & Medicaid Services, or CMS, under the Affordable Care Act, approximately an additional 18 million lives will be added to Medicaid by 2019. In addition, the Affordable Care Act includes a number of provisions for combating fraud and abuse throughout the healthcare system, allows for significant increases in funding for program integrity initiatives and provides for the creation of insurance exchanges. The Affordable Care Act largely preserves and builds upon the employer-sponsored health coverage model. However, under the Affordable Care Act, employers are faced with new compliance guidelines, coverage requirements and mandates that will challenge their systems and processes and will likely raise their healthcare costs. We plan to build on our existing partnerships with states, the federal government, and health plans to provide services that address the program integrity, fraud and abuse initiatives created by the Affordable Care Act and to assist these clients in meeting the requirements of the Affordable Care Act. In addition, we believe that we are well-positioned to work with employers to address the new requirements of the Affordable Care Act and plan to work with our clients to develop collaborations that support the overarching goal of controlling healthcare costs.

In addition to the information provided below, you should refer to the items disclosed as our Critical Accounting Policies in Part II, Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations of our Annual Report.

Table of Contents

SUMMARY OF OPERATING RESULTS

Three Months Ended September 30, 2011 Compared to Three Months Ended September 30, 2010

The following table sets forth, for the periods indicated, certain items in our consolidated statements of income expressed as a percentage of revenue:

	Three months ended September 30, 2011	2010
Revenue	100.0%	100.0%
Cost of service		
Compensation	34.4%	34.0%
Data processing	6.5%	5.7%
Occupancy	4.1%	4.4%
Direct project costs	10.7%	12.3%
Other operating costs	5.0%	5.7%
Amortization of intangibles	1.8%	2.1%
Total cost of services	62.5%	64.2%
Selling, general, and administrative expenses	11.4%	13.0%
Total operating expenses	73.9%	77.2%
Operating income	26.1%	22.8%
Interest expense	0%	0.0%
Other income, net	0.1%	0.0%
Interest income	0%	0.0%
Income before income taxes	26.2%	22.8%
Income taxes	(10.6)%	(9.0)%
Net income	15.6%	13.8%

Revenue for the three months ended September 30, 2011 was $92.4 million, an increase of $12.4 million, or 15.4%, compared to revenue of $80.0 million in the same quarter for the prior year. Organic growth in existing client accounts, together with changes in the yield and scope of those projects, and differences in the timing of when client projects were completed in the current year compared to the prior year, provided $7.6 million of the increase in revenue. Revenue generated by our 2010 acquisitions, AMG-SIU and Chapman Kelly, was $1.7 million more than in the same period last year. Revenue generated by sixteen new clients for whom there was no revenue in the same quarter of the prior year was $3.1 million.

Compensation expense as a percentage of revenue was 34.4% for the three months ended September 30, 2011, compared to 34.0% for the three months ended September 30, 2010. Compensation expense for the current quarter was $31.8 million, a $4.6 million, or 16.7%, increase over compensation expense of $27.2 million for the same quarter in the prior year. During the quarter ended September 30, 2011, we averaged 1,608 employees, a 12.1% increase over our average of 1,434 employees during the quarter ended September 30, 2010. This increase reflects the addition of new staff as a result of our acquisitions of AMG-SIU and Chapman Kelly during the second and third quarters of 2010, respectively, and the addition of staff in the areas of client support, technical support and operations.

Data processing expense as a percentage of revenue was 6.5% for the three months ended September 30, 2011, compared to 5.7% for the three months ended September 30, 2010. Data processing expense was $6.0 million for the current quarter, an increase of $1.4 million, or 30.5%, over data processing expense of $4.6 million for the same quarter in the prior year. Revenue growth as well as acquisitions drove the need for increased capacity in our data processing environment. This increase reflects $0.6 million in additional software related costs, $0.5 million in additional hardware costs, and $0.3 million in additional data communications and data costs due to the growth of our business, including the number of field offices and employees.

Occupancy expense as a percentage of revenue was 4.1% for the three months ended September 30, 2011, compared to 4.4% for the three months ended September 30, 2010. Occupancy expense for the current quarter was $3.8 million, a $0.3 million, or 8.7%, increase compared to occupancy of expense of $3.5 million for the same quarter in the prior year. This increase primarily reflects $0.3 million in additional rent and related expense.

Direct project expense as a percentage of revenue was 10.7% for the three months ended September 30, 2011, compared to 12.3% for the three months ended September 30, 2010. This decrease was primarily due to the cessation of our use of a large subcontractor. Direct project expense for the current quarter was $9.9 million, a $0.1 million, or 0.8%, increase, compared to direct project expense of $9.8 million for the same quarter in the prior year. This increase resulted from a $1.0 million increase for temporary help, consultants and marketing partners, a $0.1 million increase in project-specific software costs, and was partially offset by a $0.5 million decrease for subcontractor expenses, and a $0.5 million decrease for bad debt expense.

Other operating costs as a percentage of revenue were 5.0% for the three months ended September 30, 2011 compared to 5.7% for the three months ended September 30, 2010. Other operating costs for the current quarter were $4.7 million, an increase of $0.1 million, or 1.6%, compared to operating costs of $4.6 million for the same quarter in the prior year. This increase primarily resulted from $0.1 million in additional travel related expenses.

Amortization of acquisition-related software and intangibles as a percentage of revenue was 1.8% for the three months ended September 30, 2011, compared to 2.1% for the three months ended September 30, 2010. Amortization of acquisition-related software and intangibles for the current quarter was $1.7 million, approximately equivalent to the expense for the same quarter in the prior year. Increased amortization of $0.1 million related to our acquisitions of AMG-SIU and Chapman Kelly which was offset by decreases related to the intangible assets becoming fully amortized.

Selling, general, and administrative expense as a percentage of revenue was 11.4% for the three months ended September 30, 2011 compared to 13.0% for the three months ended September 30, 2010. The decrease is primarily due to economies of scale in delivering selling, general, and administrative services. Selling, general, and administrative expense for the current quarter was $10.6 million, a $0.2 million, or 1.4%, increase compared to $10.4 million for the same quarter in the prior year. During the quarter ended September 30, 2011, we averaged 124 corporate employees, a 6.9% increase over our average of 116 corporate employees during the quarter ended September 30, 2010. Compensation expense decreased by $0.1 million due to savings on fringe benefits. Data processing expense increased by $0.3 million relating to expenses for hosting services and disaster recovery preparedness.

Operating income for the three months ended September 30, 2011 was $24.1 million, an increase of $5.8 million, or 31.7%, compared to $18.3 million for the three months ended September 30, 2010. This increase was primarily the result of increased revenue, which was partially offset by incremental operating costs incurred during the quarter ended September 30, 2011.

Interest expense was $19,000 for the three months ended September 30, 2011 and $24,000 for the three months ended September 30, 2010. Interest expense represents commitment fees for our Credit Agreement which expired in September 2011 and issuance fees for our Letter of Credit. Interest income was $14,000 for the three months ended September 30, 2011, compared to interest income of $32,000 for the three months ended September 30, 2010. Net other income primarily relating to rental income from our office building in Irving, Texas was $165,000 for the quarter ended September 30, 2011 compared to expense of $31,000 in the prior year period. We purchased the office building in Irving, Texas in June 2010.

We recorded income tax expense of $9.8 million for the quarter ended September 30, 2011, compared to income tax expense of $7.2 million for the three months ended September 30, 2010, an increase of $2.6 million. Our effective tax rate increased to 40.5% for the quarter ended September 30, 2011 from 39.5% for the quarter ended September 30, 2010, primarily due to a change in state apportionments and permanent differences. The principal difference between the statutory rate and our effective rate is state taxes.

Net income of $14.4 million in the current quarter represents an increase of $3.4 million, or 30.5%, compared to net income of $11.0 million in the same quarter for the prior year.

Table of Contents

Nine Months Ended September 30, 2011 Compared to Nine Months Ended September 30, 2010

The following table sets forth, for the periods indicated, certain items in our consolidated statements of income expressed as a percentage of revenue:

	Nine months ended September 30,	
	2011	2010
Revenue	100.0%	100.0%
Cost of service		
Compensation	35.8%	35.4%
Data processing	6.3%	5.9%
Occupancy	4.3%	4.5%
Direct project costs	11.5%	11.9%
Other operating costs	5.1%	5.4%
Amortization of intangibles	1.9%	2.1%
Total cost of services	64.9%	65.2%
Selling, general, and administrative expenses	12.1%	13.4%
Total operating expenses	77.0%	78.6%
Operating income	23.0%	21.4%
Interest expense	0.0%	0.0%
Other income, net	0.2%	0.0%
Interest income	0.0%	0.0%
Income before income taxes	23.2%	21.4%
Income taxes	(9.3)%	(8.5)%
Net income	13.9%	12.9%

Revenue for the nine months ended September 30, 2011 was $264.2 million, an increase of $48.5 million, or 22.5%, compared to revenue of $215.7 million in the same quarter for the prior year. Organic growth in existing client accounts, together with changes in the yield and scope of those projects, and differences in the timing of when client projects were completed in the current year compared to the prior year, provided $35.0 million of the increase in revenue. Revenue generated by our 2010 acquisitions, AMG-SIU and Chapman Kelly, was $6.7 million more than in the same period last year. Revenue generated by sixteen new clients for whom there was no revenue in the same nine month period of the prior year was $6.9 million. Expired contracts accounted for a decrease of $0.1 million.

Compensation expense as a percentage of revenue was 35.8% for the nine months ended September 30, 2011, compared to 35.4% for the nine months ended September 30, 2010. Compensation expense for the current period was $94.6 million, an $18.2 million, or 23.8%, increase over compensation expense of $76.4 million for the same period in the prior year. During the nine months ended September 30, 2011, we averaged 1,614 employees, a 21.3% increase over our average of 1,331 employees during the nine months ended September 30, 2010. This increase reflects the addition of new staff as a result of our acquisitions of AMG-SIU and Chapman Kelly during the second and third quarters of 2010, respectively, and the addition of staff in the areas of client support, technical support and operations.

Data processing expense as a percentage of revenue was 6.3% for the nine months ended September 30, 2011, compared to 5.9% for the nine months ended September 30, 2010. Data processing expense was $16.6 million for the nine months ended September 30, 2011, an increase of $3.9 million, or 30.9%, over data processing expense of $12.7 million for the same period for the prior year. Revenue growth as well as acquisitions drove the need for increased capacity in our data processing environment. This increase reflects $2.0 million in additional software related costs, $1.5 million in additional hardware costs, and $0.4 million in additional data communications and data costs due to the growth of our business, including the number of field offices and employees.

Occupancy expense as a percentage of revenue was 4.3% for the nine months ended September 30, 2011, compared to 4.5% for the nine months ended September 30, 2010. Occupancy expense for the current period was $11.3 million, a $1.7 million, or 17.5%, increase compared to occupancy expense of $9.6 million for the same period in the prior year. This increase reflects a $1.1 million increase in rent and related expense, $0.3 million in additional depreciation of leasehold improvements, furniture and equipment, and $0.3 million in additional telephone expense.

Direct project expense as a percentage of revenue was 11.5% for the nine months ended September 30, 2011, compared to 11.9% for the nine months ended September 30, 2010. Direct project expense for the current period was $30.5 million, a $4.9 million, or 19.3%, increase, compared to direct project expense of $25.6 million for the same period in the prior year. This increase resulted from a $3.2 million increase for temporary help, consultants and marketing partners, a $1.1 million increase for subcontractor expenses, a $0.4 million increase for lockbox, postage and delivery expense and a $0.2 million increase for project-specific software costs.

Other operating costs as a percentage of revenue were 5.1% for the nine months ended September 30, 2011 compared to 5.4% for the nine months ended September 30, 2010. Other operating costs for the current period were $13.4 million, an increase of $1.7 million, or 14.6%, compared to operating costs of $11.7 million for the same period in the prior year. This increase resulted from additional expenses of $0.5 million in non-recurring employee relocation and training expenses, $0.4 million in additional accretion expense related to the future contingent payment that may be payable to the former owners of AMG-SIU, $0.3 million in additional professional services, consisting of temporary help and consulting services, $0.3 million in additional travel related expenses and $0.2 million in additional supplies, delivery and other office-related expenses.

Amortization of acquisition-related software and intangibles as a percentage of revenue was 1.9% for the nine months ended September 30, 2011, compared to 2.1% for the nine months ended September 30, 2010. Amortization of acquisition-related software and intangibles for the current period was $5.0 million, a $0.4 million, or 10.6%, increase compared to amortization of $4.6 million for the same period in the prior year. The increase resulted from $1.0 million in additional expenses related to our acquisitions of AMG-SIU and Chapman Kelly for which there was less amortization expense in the prior year period due to the timing of the acquisitions, which was partially offset by a reduction of $0.6 million related to the intangible assets becoming fully amortized.

Selling, general, and administrative expense as a percentage of revenue was 12.1% for the nine months ended September 30, 2011 compared to 13.4% for the nine months ended September 30, 2010. The decrease is primarily due to economies of scale in delivering selling, general, and administrative services. Selling, general, and administrative expense for the current period was $31.9 million, a $3.0 million, or 10.5%, increase compared $28.9 million for the same period in the prior year. During the period ended September 30, 2011, we averaged 120 corporate employees, a 6.2% increase over our average of 113 corporate employees during the period ended September 30, 2010. Compensation expense increased by $0.5 million as a result of increased salaries and related fringe benefits expense. Other operating expenses increased by $1.6 million in additional non-recurring staff relocation and training expenses, professional fees, including consultants, legal fees and costs associated with annual audit expenses and SEC filings, and travel. Data processing expenses increased by $1.1 million due to additional expenses for disaster recovery preparedness, software costs and hosting service fees. Occupancy expenses decreased by $0.2 million primarily due to lower space utilization.

Operating income for the nine months ended September 30, 2011 was $60.6 million, an increase of $14.4 million, or 31.3%, compared to $46.2 million for the nine months ended September 30, 2010. This increase was primarily the result of increased revenue, which was partially offset by incremental operating costs incurred during the period ended September 30, 2011.

Interest expense was $65,000 for the nine months ended September 30, 2011 and $70,000 for the nine months ended September 30, 2010. Interest expense represents commitment fees for our Credit Agreement which expired in September 2011 and issuance fees for our Letter of Credit. Interest income was $50,000 for the nine months ended September 30, 2011, compared to interest income of $73,000 for the nine months ended September 30, 2010. Net other income primarily relating to rental income from our office building in Irving, Texas was $714,000 for the period ended September 30, 2011, compared to expense of $31,000 in the nine months ended September 30, 2010. We purchased the office building in Irving, Texas in June 2010.

We recorded income tax expense of $24.7 million for the nine months ended September 30, 2011, compared to income tax expense of $18.4 million for the nine months ended September 30, 2010, an increase of $6.3 million. Our effective tax rate increased to 40.3% for the nine months ended September 30, 2011 from 39.9% for the nine months ended September 30, 2010, primarily due to a change in state apportionments and permanent differences. The principal difference between the statutory rate and our effective rate is state taxes.

Net income of $36.7 million in the current period represents an increase of $9.0 million, or 32.1%, compared to net income of $27.7 million in the same period for the prior year.

Contractual Obligations

There have been no material changes in our contractual obligations as presented in our Annual report on Form 10-K for the year ended December 31, 2010.

Table of Contents

Off-Balance Sheet Arrangements

We do not have any off-balance sheet arrangements. See Footnote 5 of the Notes to Unaudited Consolidated Financial Statements in this Quarterly Report on Form 10-Q.

Liquidity and Capital Resources

This data should be read in conjunction with our Consolidated Statements of Cash Flows.

(In thousands)	**September 30, 2011**	**December 31, 2010**
Cash and cash equivalents	$ 140,451	$ 94,836
Working Capital	$ 204,761	$ 147,546

A summary of our cash flows is as follows:

	Nine months ended	
(In thousands)	**September 30, 2011**	**September 30, 2010**
Net cash provided by operating activities	$ 49,090	$ 35,065
Net cash used for investing activities	$ (19,742)	$ (47,682)
Net cash provided by financing activities	$ 16,267	$ 13,789
Net increase in cash and cash equivalents	$ 45,615	$ 1,172

Based upon the nature of our business and strong financial position, we believe we have adequate liquidity to meet our business requirements under current market conditions for the next twelve months. Our principal source of cash has been revenue from operations. The primary uses of cash are compensation expenses, data processing, direct project costs and selling and general administration expenses. Other sources of cash include proceeds from the exercise of stock options. We expect that positive operating cash flows will continue to be the primary source of liquidity for our operating needs.

Due to our significant operating cash flows as well as access to capital markets, we continue to believe that we have the ability to meet our liquidity needs for the foreseeable future, which include:

- the working capital requirements of our operations;
- investments in our business; and,

- business-development activities.

Cash Flows from Operating Activities

Net cash provided by operating activities for the nine-month period ended September 30, 2011 increased by $14.0 million to $49.0 million as compared to the nine-month period ended September 30, 2010. The increase in net cash provided by operating activities was primarily attributed to the higher net income.

The number of days sales outstanding as of September 30, 2011 increased to 83 days from 78 days at December 31, 2010.

Operating cash flows could be adversely affected by a decrease in demand for our services or if contracts with our largest clients are cancelled. The majority of our client relationships have been in place for several years, as a result, we do not expect any decrease in the demand for our services in the near term.

Cash Flows from Investing Activities

Net cash used in investing activities for the nine-month period ended September 30, 2011 decreased by $27.9 million to $19.7 million as compared to the nine-month period ended September 30, 2010. The decrease in net cash used in investing activities was primarily attributed to a decrease in acquisition activities during the period.

Table of Contents

Cash Flows from financing activities

Net cash provided by financing activities for the nine-month period ended September 30, 2011 increased by $2.4 million to $16.2 million as compared to the nine-month ended September 30, 2010. The increase in net cash provided by financing activities was primarily attributed to the proceeds from the exercise of stock options.

Recently Issued Accounting Pronouncements

See Recently Issued Accounting Pronouncements in Note 1 of the Notes to Consolidated Financial Statements.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

At September 30, 2011, we were not a party to any derivative financial instruments. We conduct all of our business in U.S. currency and hence do not have direct foreign currency risk. Further, we currently invest substantially all of our excess cash in short-term investments, primarily money market accounts, where returns effectively reflect current interest rates. As a result, market interest rate changes may impact our interest income or expense. The impact will depend on variables such as the magnitude of rate changes and the level of borrowings or excess cash balances. We do not consider this risk to be material. We manage such risk by continuing to evaluate the best investment rates available for short-term, high quality investments.

Item 4. Controls and Procedures

We maintain disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act) that are designed to ensure that information required to be disclosed by us in reports that we file under the Exchange Act is recorded, processed, summarized and reported as specified in the SEC s rules and forms, and that such information required to be disclosed by us in reports that we file under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and our Chief Financial Officer, to allow timely decisions regarding required disclosure.

As required by Rule 13a-15(b) under the Exchange Act, management, with the participation of our Chief Executive Officer and Chief Financial Officer, performed an evaluation of the effectiveness of our disclosure controls and procedures as of September 30, 2011. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this quarterly report.

There have been no changes in our internal control over financial reporting identified in connection with the evaluation of our controls performed during the three months ended September 30, 2011 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II OTHER INFORMATION

Item 1A. Risk Factors

Risks that could have a negative impact on our business, results of operations and financial condition include without limitation (i) the development by competitors of new or superior services or products or the entry into the market of new competitors; (ii) all the risks inherent in the development, introduction, and implementation of new products and services; (iii) the loss of a major customer, customer dissatisfaction or early termination of customer contracts triggering significant costs or liabilities; (iv) variations in our results of operations; (v) negative results of government reviews, audits or investigations to verify our compliance with contracts and applicable laws and regulations; (vi) changing conditions in the healthcare environment, particularly as they relate to current healthcare reform initiatives; (vii) government regulatory, political and budgetary pressures that could affect the procurement practices and operations of healthcare organizations, reducing the demand for our services; and (viii) our failure to comply with laws and regulations governing health data or to protect such data from theft and misuse. A more detailed description of each of these and other risk factors can be found under the caption Risk Factors in our most recent Annual Report on Form 10-K, filed with the SEC on March 1, 2011.

The risks described in our Annual Report on Form 10-K, as updated by our quarterly reports on Form 10-Q, are not the only risks facing our Company. Additional risks and uncertainties not currently known to us, or that we currently deem to be immaterial, may also materially adversely affect our business, financial condition and/or operating results.

We may not complete the acquisition of HDI Holdings, Inc. within the time frame we anticipate, or at all; the acquired business may underperform relative to our expectations or cause our financial results to differ from our or the investment community s expectations; and we may not be able to achieve anticipated cost savings or other synergies.

We expect the acquisition of HDI Holdings, Inc. to close during the fourth quarter of 2011. The acquisition is subject to a number of closing conditions, and completion of the acquisition is subject to a number of additional risks and uncertainties. The unpredictability of the business and regulatory conditions affecting the industries in which we and HDI Holdings, Inc. operate, the availability of financing for the acquisition on terms we currently expect or at all, and other risks and uncertainties may adversely affect our ability to complete the acquisition within the time frame we anticipate or at all.

In addition, if the acquisition of HDI Holdings, Inc. is consummated, we may face difficulties integrating the acquired business, the acquired business may underperform relative to our expectations, it may cause our financial results to differ from our own or the investment community s expectations and we may not be able to achieve anticipated cost savings or other synergies.

Item 5. Other Information

On September 29, 2011, the Compensation Committee of the Board of Directors determined to increase the target bonuses of certain of our executive officers effective as of January 1, 2012, as follows: (i) Mr. Lucia s target bonus was increased from 65% of

Table of Contents

his base salary to 100% of his base salary and (ii) Messrs. Hosp, Curtin and Mses. Dragonetti and Perrin from 50% of their respective base salaries to 65% of their respective base salaries.

Item 6. **Exhibits**

The Exhibits filed as part of this Quarterly Report on Form 10-Q are listed on the Exhibit Index immediately following the Signatures.

Table of Contents

SIGNATURES

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

Date:	November 9, 2011	**HMS HOLDINGS CORP.**	
		By:	**/s/ William C. Lucia** William C. Lucia President and Chief Executive Officer and Duly Authorized Officer (Principal Executive Officer)
		By:	**/s/ Walter D. Hosp** Walter D. Hosp Chief Financial Officer and Duly Authorized Officer (Principal Financial Officer)

Table of Contents

Exhibit Index

Exhibit No.	Description
31.1	Rule 13a-14(a)/15d-14(a) Certification of the Principal Executive Officer of HMS Holdings Corp., as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Rule 13a-14(a)/15d-14(a) Certification of the Principal Financial Officer of HMS Holdings Corp. , as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Section 1350 Certification of the Principal Executive Officer of HMS Holdings Corp. , as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Section 1350 Certification of the Principal Financial Officer of HMS Holdings Corp. , as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

Furnished herewith