OLYMPIC STEEL INC
Form DEF 14A
March 21, 2017

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

SCHEDULE 14A

(RULE 14a-101)

SCHEDULE 14A INFORMATION

Proxy Statement Pursuant to Section 14(a) of the

Securities Exchange Act of 1934

(Amendment No.)

Filed by the Registrant Filed by a Party other than the Registrant

Check the appropriate box:

Preliminary Proxy Statement

Confidential, for Use of the Commission Only (as permitted by Rule 14a-6(e)(2))

Definitive Proxy Statement

Definitive Additional Materials

Soliciting Material Pursuant to Section 240.14a-12

Olympic Steel, Inc.

(Name of Registrant as Specified In Its Charter)

(Name of Person(s) Filing Proxy Statement)

Payment of Filing Fee (Check the appropriate box):

No fee required.

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(1) Title of each class of securities to which transaction applies:

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(1) Amount Previously Paid:

(2) Form, Schedule or Registration Statement No.:

(3) Filing Party:

(4) Date Filed:

Olympic Steel, Inc., 22901 Millcreek Boulevard, Suite 650, Highland Hills, Ohio 44122 (216) 292-3800

To Our Shareholders:

You are invited to attend the 2017 Annual Meeting of Shareholders of Olympic Steel, Inc. to be held at 5096 Richmond Road, Bedford Heights, Ohio 44146, on April 28, 2017 at 10:00 a.m. EDT. We are pleased to enclose the notice of the 2017 Annual Meeting of Shareholders, together with a Proxy Statement, a Proxy and an envelope for returning the Proxy.

You are asked to: (1) approve the election of Directors nominated by the Board of Directors; (2) ratify the selection of Olympic Steel, Inc.'s independent auditors for the year ending December 31, 2017; (3) approve, on an advisory basis, our named executive officer compensation; and (4) recommend, on an advisory basis, the frequency of shareholder votes on named executive officer compensation. Your Board of Directors unanimously recommends that you vote "FOR" all of the Director nominees nominated by the Board, "FOR" the ratification of the independent auditors selected for the year ending December 31, 2017 and our named executive officer compensation and for a frequency of "EVERY YEAR" in regards to the frequency of shareholder votes on named executive officer compensation. Please carefully review the Proxy Statement and then complete and sign your Proxy and return it promptly. If you attend the meeting and decide to vote in person, you may withdraw your Proxy at the meeting.

Your time and attention to this letter and the accompanying Proxy Statement and Proxy is appreciated.

Sincerely,

Michael D. Siegal

Chairman and Chief Executive Officer

March 21, 2017

Olympic Steel, Inc., 22901 Millcreek Boulevard, Suite 650, Highland Hills, Ohio 44122 (216) 292-3800

NOTICE OF ANNUAL MEETING OF SHAREHOLDERS

TO BE HELD APRIL 28, 2017

Notice is hereby given that the 2017 Annual Meeting of Shareholders of Olympic Steel, Inc., an Ohio corporation, which is referred to as the Company, will be held on April 28, 2017, at 5096 Richmond Road, Bedford Heights, Ohio 44146, at 10:00 a.m. EDT, for the following purposes:

1. To elect the following Directors to the class whose two-year term will expire in 2019: Michael D. Siegal, Arthur F. Anton, Donald R. McNeeley and Michael G. Rippey;

2. To ratify the selection of PricewaterhouseCoopers LLP as the Company’s independent auditors for the year ending December 31, 2017;

3. To approve, on an advisory basis, our named executive officer compensation;

4. To recommend, on an advisory basis, the frequency of shareholder votes on named executive officer compensation; and

5. To transact any other business properly brought before the 2017 Annual Meeting of Shareholders or any adjournment or postponement of the 2017 Annual Meeting of Shareholders.

Only shareholders of record of the Company’s common stock on the books of the Company at the close of business on March 10, 2017 will be entitled to vote at the 2017 Annual Meeting or any adjournment or postponement of the 2017 Annual Meeting.

Your vote is important. All shareholders are invited to attend the 2017 Annual Meeting in person. However, to ensure your representation at the 2017 Annual Meeting, please mark, date and sign the enclosed proxy, and return it promptly in the enclosed envelope. Any shareholder attending the 2017 Annual Meeting may vote in person even if the shareholder returned a proxy.

By Order of the Board of Directors

Christopher M. Kelly

Secretary

Cleveland, Ohio

March 21, 2017

The enclosed proxy is being solicited on behalf of the Board of Directors of the Company and can be returned in the enclosed envelope, which requires no postage if mailed in the United States.

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2017 ANNUAL MEETING

April 28, 2017

THE PROXY AND SOLICITATION

This Proxy Statement is being mailed on or about March 21, 2017 to the shareholders of Olympic Steel, Inc., which is referred to as the "Company", "we," "our" or "us," in connection with the solicitation by the Company's Board of Directors, which is referred to as the Board, of the enclosed form of proxy for the 2017 Annual Meeting of Shareholders, which is referred to as the Annual Meeting, to be held on April 28, 2017, at 5096 Richmond Road, Bedford Heights, Ohio 44146, at 10:00 a.m. EDT. Pursuant to the Title XVII, Chapter 1701 of the Ohio Revised Code, any shareholder signing and returning the enclosed proxy has the power to revoke it by giving notice of such revocation to the Company in writing or at the Annual Meeting before any vote with respect to the matters set forth therein is taken. The representation in person or by proxy of at least a majority of the outstanding shares of the common stock of the Company, which we refer to as the Common Stock, entitled to vote is necessary to provide a quorum at the Annual Meeting. Abstentions and broker non-votes will be counted in determining whether a quorum has been achieved.

The Company will bear the expense of preparing, printing and mailing this Proxy Statement. Although the Company has not retained a proxy solicitor to aid in the solicitation of proxies, it may do so in the future if the need arises, and does not believe that the cost of any such proxy solicitor will be material. In addition to solicitation of proxies by mail, certain Directors, officers and other employees of the Company, none of whom will receive additional compensation therefor, may solicit proxies by telephone, facsimile, electronic mail or by personal contacts. The Company will request brokers, banks and other custodians, nominees and fiduciaries to send proxy materials to beneficial owners and will, upon request, reimburse them for their out-of-pocket expenses.

PURPOSES OF ANNUAL MEETING

The Annual Meeting has been called for the purposes of: (1) electing the following Directors to the class whose two-year term will expire in 2019: Michael D. Siegal, Arthur F. Anton, Donald R. McNeeley and Michael G. Rippey; (2) ratifying the selection of PricewaterhouseCoopers LLP, which is referred to as PwC, as the Company's independent auditors for the year ending December 31, 2017; (3) approving, on an advisory basis, our named executive officer compensation; (4) recommending, on an advisory basis, the frequency of shareholder votes on named executive officer compensation; and (5) transacting such other business as may properly come before the Annual Meeting and any adjournments thereof.

The persons named in the enclosed proxy have been selected by the Board and will vote Common Stock represented by valid proxies. Unless otherwise indicated in the enclosed proxy, they intend to vote “FOR” the election of the Director-nominees named herein, “FOR” the ratification of the selection of PwC as the Company’s independent auditors for the year ending December 31, 2017, “FOR” the approval, on an advisory basis, of our named executive officer compensation and for a frequency of “EVERY YEAR” in regards to the frequency of shareholder votes on named executive officer compensation.

VOTING SECURITIES

The Board has established the close of business on March 10, 2017 as the record date for determining shareholders entitled to notice of the Annual Meeting and to vote. On that date, 10,963,863 shares of Common Stock were outstanding and entitled to one vote per share on all matters properly brought before the Annual Meeting.

PROPOSAL ONE

ELECTION OF DIRECTORS

The Board currently consists of eight members and is divided into two classes, whose members serve for a staggered, two-year term. The term of one class, which currently consists of four Directors, expires in 2018; the term of the other class, which currently consists of four Director nominees, expires at the 2017 Annual Meeting.

The Board has nominated Michael D. Siegal, Arthur F. Anton, Donald R. McNeeley and Michael G. Rippey to be elected as Directors for a two-year term. The two-year term will end upon the election of Directors at the 2019 Annual Meeting of Shareholders.

At the Annual Meeting, the shares of Common Stock represented by valid proxies, unless otherwise specified, will be voted to elect the Director-nominees. Each individual nominated for election as a Director of the Company has agreed to serve if elected. However, if any nominee becomes unable or unwilling to serve if elected, the proxies will be voted for the election of such other person as may be recommended by the Board. The Board has no reason to believe that the persons listed as nominees will be unable or unwilling to serve.

Directors will be elected by a plurality of the votes cast at the Annual Meeting. Accordingly, abstentions and broker non-votes will have no effect in determining the outcome of the vote on the election of Directors. Certain information regarding each of the Company's current Directors, including his principal occupation and directorships during the past five years, is set forth below.

DIRECTOR NOMINEES

Michael D. Siegal, age 64, joined the Board in 1984. He became Chief Executive Officer of the Company in 1984 and assumed the role of Chairman of the Board in 1994. Since 2014, Mr. Siegal has served on the board of directors of Cliffs Natural Resources Inc., a mining and natural resources company. He also serves on the board of directors of the Development Corporation of Israel and the Jewish Agency for Israel. Mr. Siegal has previously served on the board of directors of the Metals Service Center Institute, or MSCI, a metals industry trade association, University Hospitals of Cleveland and the Rock and Roll Hall of Fame and Museum. He also previously served as the Board Chair of the Jewish Federation of North America and the Jewish Federation of Cleveland. With over 30 years of executive experience at the Company, Mr. Siegal possesses proven managerial skills and firsthand knowledge of nearly every aspect of the Company's business operations. As a member of the founding family of the Company, Mr. Siegal also brings to the Board knowledge and understanding of the evolution of a family business into a successful public company. Mr. Siegal is also a substantial long-term shareholder of the Company.

Arthur F. Anton, age 59, joined the Board in 2009. Since 2004, Mr. Anton has served as the President and Chief Executive Officer of the Swagelok Company, a fluid systems technologies company. Since 1998, Mr. Anton has served in the following positions at the Swagelok Company: President and Chief Operating Officer, from 2001 to 2004; Executive Vice President, from 2000 to 2001; and Chief Financial Officer, from 1998 to 2000. He is a former Partner of Ernst & Young LLP, a professional services organization. Since 2006, Mr. Anton has served on the board of directors of The Sherwin-Williams Company, a paint coatings manufacturer. He also serves on the board of directors of University Hospitals of Cleveland and Forest City Real Estate Trust, Inc., a national real estate company. As the head of a large private corporation, Mr. Anton provides valuable insight into the successful operation of a business, which serves him well as a member of the Board, Chairman of the Audit and Compliance Committee and as a member of the Compensation Committee. As a former partner at Ernst & Young LLP, the Chair of the audit committee of The Sherwin-Williams Company and a member of the audit committee of Forest City Real Estate Trust, Inc., Mr. Anton possesses a detailed understanding of accounting principles and practice.

Donald R. McNeeley, age 62, joined the Board in 2011. Since 1990, he has served as the President of Chicago Tube & Iron Company, or CTI, a fabricator of metal tubing, pipe, bar, valves and fittings and pressure parts that is now a subsidiary of the Company. From 1990 until 2015, Mr. McNeeley also served as the Chief Operating Officer of CTI. He is also an adjunct professor at Northwestern University. Mr. McNeeley serves on the board of directors of Vail Rubber Industries, a manufacturer of industrial roll coverings, and Saulsbury Industries, an engineering and construction company to heavy-industrial markets. He is also the Chair of the audit committee of Saulsbury Industries. Mr. McNeeley is a former Chairman of the MSCI. Mr. McNeeley's years of experience at CTI, as well as his academic background, provide a wealth of knowledge regarding the steel pipe and tubing industry, making him a valuable member of the Board.

Michael G. Rippey, age 59, joined the Board in 2015. Since 2015, he has served as Senior Advisor to Nippon Steel USA, a steel-making company. Mr. Rippey served as Chairman of ArcelorMittal USA, a steel and mining company, from 2014 to 2015. Mr. Rippey served as President and Chief Executive Officer of ArcelorMittal USA from 2006 to 2014. From 1984 to 2006, he held various positions at Inland Steel and Ispat Inland, predecessor companies to ArcelorMittal USA. Mr. Rippey currently serves on the Board of Directors of the Chicagoland Chamber of Commerce. He has previously served on the Board of Directors of the following organizations: Children's Home + Aid, the American Iron & Steel Institute, where he had also served as past Chairman of the Board, and the National Association of Manufacturers. He is also a member of the Dean's Council and an Alumni Fellow at Indiana University. Mr. Rippey brings to the Board a wealth of knowledge of the metals industry. Mr. Rippey serves on both the Nominating and Compensation Committees and, effective March 2017, the Audit and Compliance Committee.

DIRECTORS WITH TERMS THAT EXPIRE IN 2018

David A. Wolfort, age 64, joined the Board in 1987. He became Chief Operating Officer of the Company in 1995, continuing in that role until 2016, and assumed the role of President in 2001, a role he continues today. Mr. Wolfort serves as a member of the United States Industry Trade Advisory Committee on Steel. He previously served on the board of directors of the MSCI and was a past Chairman of both the MSCI Political Action Committee and the MSCI Government Affairs Committee. He is a Trustee and Chair of Ohio University Board of Trustees and a Trustee of the Musical Arts Association (Cleveland Orchestra). With his years of experience at the Company, Mr. Wolfort brings to the Board a wealth of knowledge concerning the Company's business operations and the competitive landscape of the metals industry.

Ralph M. Della Ratta, age 63, joined the Board in 2004. Since 2004, he has served as the Founder and Managing Director of Western Reserve Partners LLC, an investment banking firm. Prior to this time, Mr. Della Ratta was the Senior Managing Director and Manager of the Investment Banking Division of McDonald Investments, Inc., an investment banking firm, and through a 1998 merger with KeyCorp, he served in the same capacity. Mr. Della Ratta serves on the board of directors of Western Reserve Partners LLC and TCP International Holdings Ltd. Mr. Della Ratta previously served on the board of McCormack Advisors International, a wealth management firm, and NDI, Inc., a medical investment company. Having served for most of his professional career in the investment banking industry, Mr. Della Ratta provides valuable business and financial knowledge as Lead Director and a member of the Board, the Audit and Compliance Committee and the Compensation Committee.

Dirk A. Kempthorne, age 65, joined the Board in 2010. He served as the Mayor of Boise, Idaho from 1986 to 1993, a United States Senator from Idaho from 1993 to 1999 and Governor of Idaho from 1999 to 2006. He also served as the 49th Secretary of the U.S. Department of the Interior from 2006 to 2009. Mr. Kempthorne has served as the President of The Kempthorne Group, a consulting firm, since 2009 and has served as the President & Chief Executive Officer of the American Council of Life Insurers, an insurance industry trade association, since 2010. Since 2009, Mr. Kempthorne has also served on the board of directors of FMC Corporation, a global chemical company. With his commitment to public service and his recognized national leadership, Mr. Kempthorne provides important contributions and insights as a member of the Board and as Chairman of the Nominating Committee as we execute our strategic growth initiatives.

Howard L. Goldstein, age 64, joined the Board in 2004. He has been a partner with Appelrouth, Farah & Co., a full service accounting and international business advisory firm, since 2012. Prior to 2012, Mr. Goldstein was the Managing Director of Mallah Furman, a certified public accounting firm, and had been a Senior Partner for over 25 years. Mr. Goldstein is a member of the American Institute of Certified Public Accountants, the Florida Institute of Certified Public Accountants, the Florida Board of Accounting, the New Jersey Board of Certified Public Accountants and the New Jersey Institute of Certified Public Accountants. Mr. Goldstein also serves as Vice Chair of the U.S. Board of Directors of Israel Bonds. As a certified public accountant, Mr. Goldstein's broad knowledge and deep understanding of accounting principles and financial reporting rules and regulations make him a valuable asset as a member of the Board and the Audit and Compliance Committee. Mr. Goldstein's experience with the Company has also made him a valued member of the Audit and Compliance Committee and the Nominating Committee and the Chairman of the Compensation Committee.

The Board recommends a vote "FOR" Michael D. Siegal, Arthur F. Anton, Donald R. McNeeley and Michael G. Rippey for election to the class of directors whose two-year term will expire in 2019.

CORPORATE GOVERNANCE

BOARD MEETINGS AND COMMITTEES

The Board held four regularly scheduled meetings in 2016. The Board has a standing Audit and Compliance Committee, Compensation Committee and Nominating Committee. The Audit and Compliance Committee, Compensation Committee and Nominating Committee held four, two and one meetings, respectively, in 2016. The committees receive their authority and assignments from, and report to, the Board.

All of the current Directors attended all applicable Board and committee meetings held during 2016. In addition to holding regular Board and committee meetings, the Board members and committee members also reviewed and considered matters and documents and communicated with each other apart from the meetings. Additionally, all non-management members of the Board meet separately without members of management present at every regularly scheduled Board meeting.

The Board determines the independence of each Director and each Director-nominee in accordance with the independence standards set forth in the listing requirements of the Nasdaq Stock Market, which we refer to as Nasdaq. The Board has determined that Messrs. Della Ratta, Kempthorne, Anton, Goldstein and Rippey are independent Directors, as defined in the Nasdaq listing requirements. With respect to Mr. Rippey, who, as discussed above, was the former Chairman and former President and Chief Executive Officer of ArcelorMittal USA, the Board determined that the business relationship between the Company and ArcelorMittal USA relating to the purchase of certain steel products by the Company from ArcelorMittal USA does not impair his independence.

Audit and Compliance Committee. The Audit and Compliance Committee is chaired by Mr. Anton and also consists of Messrs. Della Ratta and Goldstein and, effective March 2017, Mr. Rippey. The Audit and Compliance Committee is responsible for monitoring and overseeing our internal controls and financial reporting processes, as well as the independent audit of our consolidated financial statements by our independent auditors. Each committee member is an “independent director” as defined in the Nasdaq listing requirements and applicable rules of the Securities and Exchange Commission, which we refer to as the SEC. Each of Messrs. Anton, Rippey and Goldstein has been designated by the Board as meeting the definition of “audit committee financial expert” under SEC rules and each satisfies the Nasdaq’s professional experience requirements. The Audit and Compliance Committee operates pursuant to a written charter, which can be found on our website at www.olysteel.com. Additional information on the committee and its activities is set forth in the “Audit Committee Report” below.

Compensation Committee. The Compensation Committee is chaired by Mr. Goldstein and also consists of Messrs. Rippey, Della Ratta and Anton. Each committee member is an “independent director” as defined in the Nasdaq listing requirements. The primary purposes of the Compensation Committee are to assist the Board in meeting its responsibilities with regard to oversight and determination of executive compensation and to administer our equity-based or equity-linked compensation plans, bonus plans, supplemental executive retirement plan and deferred compensation plans after consultation with management. The Compensation Committee reviews and recommends to the Board for approval the base salary, annual bonus, long-term incentive compensation and other compensation, perquisites and special or supplemental benefits for our Chief Executive Officer and other executive officers. The Compensation Committee also makes recommendations concerning our employee benefit policies and has authority to administer our equity compensation plans. The Compensation Committee has the authority to hire compensation consultants and legal, accounting, financial and other advisors, as it deems necessary to carry out its duties. Management assists the Compensation Committee in its administration of the executive compensation program by recommending individual and Company goals and by providing data regarding performance. From time to time, our Compensation Committee engages Towers Watson, a global professional services firm that provides human resources consulting services, as an outside independent compensation consultant to advise the Compensation Committee on our compensation program. For additional information, see below under “Executive Compensation—Compensation Discussion and Analysis—Role of Compensation Consultant.” The Compensation Committee operates pursuant to a written charter, which can be found on our website at www.olysteel.com. Additional information on the committee and its activities is set forth in the “Compensation Discussion and Analysis” and “Compensation Committee Report” below.

Nominating Committee. The Nominating Committee is chaired by Mr. Kempthorne and also consists of Messrs. Goldstein and Rippey. This committee functions to advise and make recommendations to the Board concerning the selection of candidates as nominees for Directors, including those individuals recommended by shareholders. The Nominating Committee operates pursuant to a written charter, which can be found on our website at www.olysteel.com. Each committee member is an “independent director” as defined in the Nasdaq listing requirements.

CORPORATE GOVERNANCE

Shareholder Communications. Shareholders may send written communications to the Board or any one or more of the individual Directors by mail to Olympic Steel, Inc., 22901 Millcreek Boulevard, Suite 650, Highland Hills, Ohio 44122. Any shareholder who wishes to send a written communication to any member of the Board may do so in care of our Secretary, who will forward any communications directly to the Board or the individual Director(s) specified in the communication.

Director Nominations Process. The Board's process for identifying and evaluating nominees for Director consists principally of evaluating candidates who are recommended by the Nominating Committee. The Nominating Committee also may, on a periodic basis, solicit ideas for possible candidates from a number of sources, including current members of the Board, senior level executives, individuals personally known to members of the Board and employment of one or more search firms.

Except as may be required by rules promulgated by Nasdaq or the SEC, there are currently no specific, minimum qualifications that must be met by each candidate for the Board, nor are there specific qualities or skills that are necessary for one or more of the members of the Board to possess. In evaluating the suitability of the candidates, the Nominating Committee takes into consideration such factors as it deems appropriate. These factors may include, among other things, issues of character, judgment, independence, expertise, diversity of experience, length of service and other commitments. The Nominating Committee evaluates such factors, among others, and considers each individual candidate in the context of the current perceived needs of the Board as a whole and of committees of the Board.

The Nominating Committee will consider Director candidates recommended by shareholders if properly submitted. Shareholders wishing to suggest persons for consideration as nominees for election to the Board at the 2018 Annual Meeting may do so by providing written notice to us in care of our Secretary no later than December 21, 2017. Such recommendation must include the information required of Director-nominees by our Amended and Restated Code of Regulations. Assuming that a properly submitted shareholder recommendation for a potential nominee is received and appropriate biographical and background information is provided, the Nominating Committee and the Board will follow the same process and apply the same criteria as they do for candidates submitted by other sources.

Board Leadership and Risk Oversight. Michael D. Siegal serves as both the Company's Chairman of the Board and the Company's Chief Executive Officer. The Board has no policy with respect to the separation of these offices. The Board believes that this issue is part of the succession planning process and that it is in the best interests of the Company for the Board to consider it each time that it elects the Chief Executive Officer. The Board recognizes that there may be circumstances in the future that would lead it to separate these offices, but it believes that there is no reason to do so at this time.

As both a Director and officer, Mr. Siegal fulfills a valuable leadership role that the Board believes is essential to the continued success of the Company's business operations. Mr. Siegal has served the Company in an executive role for over 30 years, and the experience and deep knowledge base he brings to both positions are invaluable. In the Board's opinion, Mr. Siegal's dual role enhances the Company's ability to coordinate long-term strategic direction with important business opportunities at the operational level and enhances his ability to provide insight and direction on important strategic initiatives impacting the Company and its shareholders to both management and the independent Directors.

In 2014, the Company created a Lead Director position, which was filled by Mr. Della Ratta. The duties of the Lead Director include, but are not limited to, the following:

- presiding at all meetings of the Board at which the Chairman is not present, including executive sessions of the independent directors;
- serving as a liaison between the Chairman and the independent Directors;
- approving information sent to the Board;
- approving meeting agendas for the Board;
- approving meeting schedules to assure that there is sufficient time for discussion of all agenda items;
- authority to call meetings of the independent Directors; and
- if requested by major shareholders, ensuring that he is available for consultation and direct communication.

The Board generally oversees the Company's risk management directly and through the Audit and Compliance Committee. The Board regularly reviews issues that present particular risks to the Company, including those involving competition, customer demands, economic conditions, planning, strategy, finance, facilities and operations. Additionally, the Audit and Compliance Committee also reviews risks relating to the Company's financial statements and financing arrangements. The Board believes that this approach provides appropriate checks and balances against undue risk taking and that the Board's leadership structure supports its risk oversight function.

Annual Meeting Attendance. The Board does not have a formal policy with regard to Directors' attendance at the Annual Meeting. However, because a Board meeting usually precedes the Annual Meeting, all Directors are urged to attend. Last year, all Directors then serving, except Mr. Anton, were present in person at the Annual Meeting.

Shareholder Approval. Our Amended and Restated Articles of Incorporation and our Amended and Restated Code of Regulations may be amended by the affirmative vote of the holders of a majority of our outstanding shares of Common Stock. Any merger involving us or the sale of all or substantially all of our assets would require the affirmative vote of the holders of a majority of our outstanding shares of Common Stock.

CODE OF ETHICS

We have adopted a Business Ethics Policy. The full text of the Business Ethics Policy is available through the "Investor Relations" section of our website under the "Corporate Governance" option at www.olysteel.com. The Business Ethics Policy applies not only to our principal executive officer and principal financial and accounting officer and controller, but also to all of our employees. We intend to disclose any amendments to the Business Ethics Policy, and all waivers of the Business Ethics Policy relating to our principal executive officer, principal financial and accounting officer and controller by posting such information on our website.

SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS

The following table sets forth certain information regarding the beneficial ownership of Common Stock as of March 10, 2017 (unless otherwise indicated) by each person or entity known to us to beneficially own 5% or more of our outstanding Common Stock based upon information furnished to us or derived by us from publicly available records.

Names of Beneficial Owners	Number of Shares Beneficially Owned(1)	Percentage of Ownership
Michael D. Siegal(2) 22901 Millcreek Blvd, Suite 650 Highland Hills, OH 44122	1,253,046	11.39%
BlackRock, Inc.(3) 55 East 52nd Street New York, NY 10055	1,111,378	10.10%
Dimensional Fund Advisors LP(4) Palisades West, Building One 6300 Bee Cave Road Austin, TX 78746	922,680	8.42%

(1) Unless otherwise indicated below, the persons named in the table above have sole voting and investment power with respect to the number of shares set forth opposite their names. In computing the number of shares beneficially owned by a person and the percentage ownership of that person, shares of Common Stock subject to options held by that person that are currently exercisable or will become exercisable within 60 days after March 10, 2017 are considered outstanding, while these shares are not considered outstanding for purposes of computing the percentage ownership of any other person.

(2) Includes 4,000 shares issuable upon the exercise of options exercisable within 60 days after March 10, 2017 and 34,319 shares issuable pursuant to restricted stock units that will be converted into shares when the individual retires from the Company.

(3) Based on Schedule 13G/A filed with the SEC on February 8, 2017 describing ownership as of December 31, 2016, which Schedule specifies that BlackRock, Inc. has sole voting power with respect to 1,098,039 of these shares and

sole investment power with respect to all of these shares.

(4) Based on Schedule 13G/A filed with the SEC on February 9, 2017 describing ownership as of December 31, 2016, which Schedule specifies that Dimensional Fund Advisors LP has sole voting power with respect to 897,028 of these shares and sole investment power with respect to all of these shares.

SECURITY OWNERSHIP OF MANAGEMENT

The following table sets forth certain information regarding the beneficial ownership of Common Stock as of March 10, 2017 by each of our Directors, each of the Executive Officers named in the summary compensation table included herein, whom we refer to as the named executive officers, and all the Directors and Executive Officers as a group.

Names of Beneficial Owners	Number of Shares Beneficially Owned(1)	Number of Additional Shares Subject to Certain Vested Restricted Stock Units(2)	Percentage of Ownership(2)
Michael D. Siegal(3)(4)	1,253,046	40,828	11.39%
David A. Wolfort(3)(15)	454,195	37,768	4.13 %
Donald R. McNeeley(5)(16)	144,538	23,713	1.32 %
Richard T. Marabito(6)	37,934	46,454	*
Richard A. Manson(7)	12,772	13,179	*
Andrew S. Greiff	5,521	30,689	*
Howard L. Goldstein(8)(9)	25,876	–	*
Ralph M. Della Ratta(8)(10)	33,446	–	*
Arthur F. Anton(11)	39,254	–	*
Dirk A. Kempthorne(12)	16,676	–	*
Michael G. Rippey(13)	11,394	–	*
All Directors, Director Nominees and Executive Officers as a group (11 persons)(14)	2,034,652	192,631	18.29%

*Less than 1%

(1) Unless otherwise indicated below, the persons named in the table above have sole voting and investment power with respect to the number of shares set forth opposite their names. In computing the number of shares beneficially owned by a person and the percentage ownership of that person, shares of Common Stock subject to options or restricted stock units held by that person that are currently exercisable or will become exercisable within 60 days after March 10, 2017 are considered outstanding, while these shares are not considered outstanding for purposes of computing the percentage ownership of any other person.

(2)

Represents shares not yet beneficially owned that are issuable pursuant to vested restricted stock units (a) that will not be converted until a qualified retirement, which cannot occur within 60 days, or (b) under our Supplemental Executive Retirement Plan that will not be converted until six months after a qualified retirement. These shares have not been included for purposes of calculating each person's percentage of beneficial ownership.

(3) Includes 4,000 shares issuable upon the exercise of options within 60 days of March 10, 2017.

(4) Includes 34,319 shares issuable pursuant to restricted stock units that will be converted into shares when the individual retires from the Company.

(5) Includes 4,000 shares held in trust for the benefit of Dr. McNeeley.

(6) Includes 8,700 shares held in various trusts for the benefit of Mr. Marabito's children. Also includes 4,170 shares issuable upon the exercise of options within 60 days of March 10, 2017.

(7) Includes 1,000 shares issuable upon the exercise of options within 60 days of March 10, 2017. Also includes 2,075 shares held in individual retirement accounts for Mr. Manson and his spouse.

(8) Includes 22,876 shares issuable pursuant to restricted stock units that will be converted into shares when the individual is no longer a Board member.

(9) Includes 3,000 shares held in a trust.

(10) Includes 600 shares held in a trust for the benefit of Mr. Della Ratta's children.

(11) Includes 17,476 shares issuable pursuant to restricted stock units that will be converted into shares when the individual is no longer a Board member.

(12) Includes 15,676 shares issuable pursuant to restricted stock units that will be converted into shares when the individual is no longer a Board member.

(13) Includes 3,094 shares issuable pursuant to restricted stock units that will be converted into shares when the individual is no longer a Board member.

(14) Includes 13,170 shares issuable upon the exercise of options within 60 days of March 10, 2017, 81,998 shares issuable pursuant to restricted stock units that will be converted into shares when the individual is no longer a Board member and 67,525 shares issuable pursuant to restricted stock units that will be converted into shares when the individual retires from Olympic Steel.

(15) Includes 32,175 shares issuable pursuant to restricted stock units that will be converted into shares when the individual retires from the Company.

(16) Includes 1,031 shares issuable pursuant to restricted stock units that will be converted into shares when the individual retires from the Company.

SECTION 16(a) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE

Section 16(a) of the Securities Exchange Act of 1934, as amended, which is referred to as the Exchange Act, requires the Company's officers and Directors, and persons who own greater than 10% of the Company's Common Stock, to file reports of ownership and changes in ownership to the SEC. Officers, directors and more than 10% shareholders are required by the SEC to furnish to the Company copies of all Section 16(a) reports they file. To the Company's knowledge, based solely upon a review of Forms 3 and 4 and amendments thereto furnished to the Company during 2016, or a written representation from the reporting person that no Form 5 is required, all filings required to be made by the Company's officers and Directors were timely made.

EXECUTIVE COMPENSATION

COMPENSATION DISCUSSION AND ANALYSIS

Introduction

We are a leading U.S. metals service center with over 60 years of experience. Our primary focus is on the direct sale and distribution of large volumes of processed carbon, coated, aluminum and stainless flat-rolled sheet, coil and plate products. Commencing with the July 1, 2011 acquisition of CTI, we also distribute metal tubing, pipe, bar, valves and fittings and we fabricate pressure parts supplied to various industrial markets. We operate as an intermediary between metal producers and manufacturers that require processed metal for their operations. As further discussed in this section, our compensation and benefit programs are designed to reward our employees when they help us achieve business objectives.

Our compensation philosophy remains pay-for-performance based. Our cash incentive plan emphasizes Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) and Return on Assets (ROA) in the calculation of incentives for our most senior executive officers.

At our 2016 Annual Meeting, we received approximately 97% approval for our advisory “Say-on-Pay” proposal to approve the compensation of our named executive officers. The Compensation Committee considered the 2016 voting results at its meetings and remains dedicated to continuous improvement to the existing executive pay programs. As a result of its considerations, the Compensation Committee implemented the executive pay practices described below.

The following discussion and analysis of our 2016 executive compensation program, which may include forward-looking statements, should be read together with the compensation tables and related disclosures that follow this section.

Compensation Philosophy and Objectives

The goals of our compensation program for our Chairman and Chief Executive Officer and the other executive officers named in the 2016 Summary Compensation Table, whom we refer to as our named executive officers, are to support our long-term business strategy and link our executives’ interests with those of our shareholders. We designed the compensation program to, among other things, provide incentives for executives to help us achieve business objectives and give the Compensation Committee the flexibility necessary to reward executives for achieving those objectives. The Compensation Committee's strategy for achieving these goals is to:

- provide each named executive officer with total compensation that is competitive compared to compensation for similarly situated executives in public and privately-held metal and metal-related companies, and similar-sized non-metal companies, in order to attract, motivate and retain highly qualified executives;

- reward performance under a cash incentive plan that provides the potential for a substantial reward through the payment of a significant incentive that increases as our EBITDA and ROA increase, but provides reduced incentive payments during periods when EBITDA and ROA decrease; and

- provide long-term incentives in the form of restricted stock unit awards that appropriately align the compensation interests of our executives with the investment interests of our shareholders in increasing shareholder value.

Role of Compensation Committee and Management

Our Compensation Committee is responsible for setting and administering the policies and plans that govern the base salaries, incentives and other compensation elements for our named executive officers.

Management has a minor role in helping the Compensation Committee administer the executive compensation program by recommending individual and Company performance goals, including offering suggestions for key metrics for use in our incentive program, and by providing data regarding actual performance. Otherwise, management is not involved in establishing executive compensation.

Role of Compensation Consultant

Towers Watson's role in the executive compensation program is to compare the base salaries, annual cash incentive awards and long-term compensation of our named executive officers to the compensation paid to executives in similar positions both within and outside the metal service center industry in order to provide market "benchmarks" for the Compensation Committee to assess in evaluating and determining the compensation of our named executive officers.

Compensation Allocation

Our executive compensation program consists of three primary components: base salary, annual cash incentive payouts and long-term compensation in the form of equity-based awards. We also provide our executives with the opportunity to participate in a 401(k) retirement and profit-sharing plan and a non-qualified defined contribution plan. Certain health, disability and life insurance and other customary fringe benefits also are available to our named executive officers, who participate in these fringe benefits on substantially the same basis as our other employees. Except for Mr. McNeeley, each named executive officer also has entered into an agreement with us that provides for certain benefits upon a change in control, as described below under "Potential Payments upon Termination or Change in Control."

In determining the relative allocation of these elements of compensation, the Compensation Committee seeks to provide an amount of long-term compensation, both in the form of equity and cash incentives, that is sufficient to align the interests of our executives with those of our shareholders, while also providing adequate short-term compensation, primarily in the form of cash, to attract and retain talented executives. The Compensation Committee takes into account various qualitative and quantitative indicators of Company and individual performance in determining the level and composition of compensation for our Chairman and Chief Executive Officer and the other named executive officers. While the Compensation Committee considers our financial and operating performance, the Compensation Committee generally does not apply any specific quantitative formula in making base salary decisions, except with respect to the cash incentive award opportunities, as described below. The Compensation Committee also appreciates the importance of achievements that may be difficult to quantify — such as individual performance — and, accordingly, recognizes qualitative factors that include successful supervision of major corporate projects and demonstrated leadership ability.

The Compensation Committee believes that the elements of the executive compensation program discussed below advance our business objectives and the interests of our shareholders by attracting and retaining the executive leadership necessary for growth and motivating our executives to increase shareholder value.

Elements of Compensation

Base Salaries. The annual base salaries of our named executive officers are based upon an evaluation of their significant contributions against established objectives as individuals and as a team, as determined by the Compensation Committee. Except for Mr. Manson, the base salaries of our named executive officers are subject to minimum amounts established in accordance with their respective employment agreements, which are described below in “Potential Payments upon Termination or Change in Control.” As noted above, when establishing base salaries for our named executive officers, the Compensation Committee considers the cash compensation offered by companies in other metal and metal-related companies, including the peer group found in “Role of Compensation Consultant” above, and obtains the recommendations of Towers Watson and management in order to determine the range of the base salaries. As mentioned above, the Compensation Committee also considered recommendations from Mr. Siegal in determining salary levels for our other named executive officers. As discussed further in the next paragraph, the Compensation Committee reviews the base salaries of our named executive officers on an individual basis periodically, rather than annually, and determines the base salary of our named executive officers after considering the above factors and the individual’s particular talents, skills, experience, industry knowledge and functional responsibilities and duties. The Compensation Committee does not consider whether an individual named executive officer has earned any incentive compensation in prior years in determining base salaries.

The base salaries paid to our named executive officers in 2016 were reviewed and approved by the Compensation Committee, and the amounts paid are reflected in the 2016 Summary Compensation Table. On December 31, 2015, Mr. Wolfort entered into a new employment contract whereby, effective January 1, 2016, his base salary was increased from $700,000 to $735,000 based upon his performance and contributions to the Company. Mr. Wolfort’s last change in base pay occurred in 2011. On July 1, 2016, Mr. McNeeley entered into a new employment contract whereby his base salary was increased from $575,000 to $675,000 based upon his performance and contributions to the Company. Mr. McNeeley’s last change in base pay occurred in 2011. On August 19, 2016, Mr. Greiff was promoted to Executive Vice President and Chief Operating Officer and became an executive officer. On that date, Mr. Greiff entered into an employment contract whereby his base salary was set at $450,000, increasing to $500,000 on July 1, 2017 and $550,000 on July 1, 2018. On November 23, 2016, Mr. Marabito entered into a new employment contract whereby, effective January 1, 2017, his base salary was increased from $450,000 to $500,000 based upon his performance and contributions to the Company. His base salary will increase to $550,000 on January 1, 2018. Mr. Marabito’s last change in base pay occurred in 2011. Messrs. Siegal’s and Manson’s base salaries remain unchanged from 2016. Messrs. Siegal’s and Manson’s last change in base pay occurred in 2011 and 2014, respectively. The Compensation Committee believes that the salaries of each of our named executive officers are reasonable when measured against the range of base salaries offered by other companies.

Annual Cash Incentive Compensation. We believe that a significant portion of the compensation paid to our named executive officers should be based on our annual performance so that the executives are appropriately motivated to maximize our operating performance each year. We have established our Senior Management Compensation Program to provide our executives, including our named executive officers, with the opportunity to earn an annual cash incentive payout.

The Senior Manager Cash Incentive Plan was implemented to emphasize the production of EBITDA and ROA. ROA is calculated by dividing annual EBITDA by our annual average net accounts receivable, average net inventory and average net property, plant and equipment. Messrs. Siegal, Marabito, Wolfort, McNeeley and Manson each participate in an incentive pool that can range from 0% to 4.267% of our EBITDA, excluding the impacts of last-in, first out (LIFO) inventory adjustments. One-half of the pool is then either increased or reduced depending on our ROA performance, as compared to a targeted ROA goal of 12%. Mr. Greiff will begin participating in this program in 2017. For 2016, Mr. Greiff earned an incentive as the President of Specialty Metals, his previous position, which was based on the pre-tax income of the Specialty Metals and Flat-Rolled segments.

For 2016, the Compensation Committee granted an annual cash incentive award opportunity for each of Messrs. Siegal, Marabito and Wolfort of 27.3% of the incentive pool, and Mr. Manson of 9.1% of the incentive pool. The Compensation Committee set the annual cash incentive payout amounts for Messrs. Siegal, Wolfort and Marabito, in light of their significant functional responsibilities and duties and their positions as the most senior-level executives, at three times those established for Mr. Manson. For 2016, no incentives were earned, however, as the Company did not meet minimum ROA requirements.

Mr. McNeeley receives a cash incentive that is one-half tied to the Senior Manager Cash Incentive Plan utilized by our other named executive officers and one-half directly tied to the ratio of CTI's actual operating profit to its budgeted operating profit. The one-half of the incentive tied to the Senior Manager Cash Incentive Plan is equal to 50% of the incentive earned individually by Messrs. Siegal, Wolfort and Marabito. The one-half tied to CTI's results provides the opportunity to earn an annual cash incentive of up to 65% of his annual base salary. The incentive is tied to the actual operating profit of CTI as compared to budgeted operating profit. For 2016, Mr. McNeeley did not earn an annual cash incentive as minimum performance objectives were not met.

Long-Term Equity-Based Compensation. The Compensation Committee believes that equity-based compensation awards are an appropriate means of aligning the interests of our executives with those of our shareholders by rewarding our executives based on increases in the price of our Common Stock. Like base salary and the annual cash incentive payments, award levels are set with regard to competitive considerations, and each individual's actual award is based upon the individual's job responsibilities, performance, potential for increased responsibility and contributions, leadership ability and commitment to our strategic efforts. The timing and amount of previous awards to, and held by, the executive is reviewed, but is only one factor considered by the Compensation Committee in determining the size of any equity-based award grants.

Equity-based compensation awards are granted under the Olympic Steel, Inc. 2007 Amended and Restated Omnibus Incentive Plan, which is referred to as the Incentive Plan. The Incentive Plan authorizes us to grant stock options, stock appreciation rights, restricted shares, restricted share units, performance shares and other stock- and cash-based awards to our employees, Directors and consultants.

For more information about our Incentive Plan and awards under that plan for 2016, see the 2016 Grants of Plan-Based Awards Table, the Outstanding Equity Awards at 2016 Fiscal Year-End Table and the accompanying narratives below.

In 2011, the Board, based upon the recommendation of the Compensation Committee, approved changes to the Senior Management Compensation Program to include an equity component in order to encourage more ownership of Common Stock by members of the senior management group, including the executive officers, to better align the interests of our executives and shareholders. Starting in 2011, the Senior Manager Compensation Plan imposed stock ownership requirements upon the executives. Each executive is required to own at least 750 shares of Common Stock for each year that the executive participates in the Senior Management Compensation Plan. Any executive that fails to meet the stock ownership requirements will be ineligible to receive any equity awards under the Company's equity compensation plans, including the Incentive Plan, until the executive satisfies the ownership requirements. To assist executives in meeting the stock ownership requirements, on an annual basis, if a participant purchases 500 shares of Common Stock on the open market, the Company will award that participant 250 shares of Common Stock. Additionally, any executive who continues to comply with the stock ownership requirements as of the five-year, 10-year, 15-year, 20-year and 25-year anniversaries of the participant's participation in the Senior Management Compensation Program will receive a restricted stock unit award with a dollar value of $25,000, $50,000, $75,000, $100,000 and $100,000, respectively. Restricted stock unit awards will convert into the right to receive shares of Common Stock upon an executive's retirement, or earlier upon the executive's death or disability or upon a change in control of the Company.

The Company decided to terminate the stock award portion of the Senior Manager Compensation Plan for all flat-rolled participants on July 1, 2016 and on January 1, 2017 for all CTI participants. Effective July 1, 2016, the cash incentive for Senior Managers is now governed by the Senior Manager Cash Incentive Plan and the stock incentive for Senior Managers is now governed by the Senior Manager Stock Incentive Plan.

On January 1, 2016, Messrs. Siegal, Wolfort, Marabito, Greiff and Manson earned their $25,000 of restricted stock unit awards. During 2016, Mr. McNeeley met the requirements of the program and received 250 shares of Common Stock. Mr. McNeeley earned his $25,000 of restricted stock unit awards on January 1, 2017.

Under the Senior Manager Stock Incentive Plan, participants are annually awarded restricted stock units equal to 10% of their base salary, subject to a maximum of $17,500 per year, and also subject to minimum financial performance requirements. The restricted stock units vest five years after the grant date and will convert into the right to receive shares of Common Stock upon an executive's retirement, or earlier upon the executive's death or disability or upon a change in control of the Company.

During 2016, Messrs. Siegal, Wolfort, Marabito, Greiff and Manson each received 640 restricted stock units. Mr. McNeeley will begin participating in the new plan on July 1, 2017.

In 2016, the Company also adopted a policy to award restricted stock units to newly-appointed named executive officers, based upon a percentage of their base salary. Upon his promotion to Executive Vice President and Chief Operating Officer, Mr. Greiff received 10,573 restricted stock units that will vest five years from the grant date, or earlier upon his death or disability or upon a change in control of the Company.

Personal Benefits and Perquisites. Our named executive officers also are eligible to receive other benefits, which the Compensation Committee believes are commensurate with the types of benefits and perquisites provided to other similarly situated executives, as determined based on the Compensation Committee's review of information supplied by Towers Watson. The Compensation Committee believes these benefits are set at a reasonable level, are highly valued by recipients, have limited cost, are part of a competitive compensation program and are useful in attracting and retaining qualified executives. They are not tied to our performance. These benefits consist of medical, dental, disability and life insurance benefits and 401(k) and profit-sharing plan contributions, pursuant to plans that are generally available to our employees. Perquisites consist of a car allowance, cell phone allowance, reimbursement for personal tax preparation and financial services fees and payment of country club dues.

Retirement and Post-Employment Benefits. We provide our executives with certain post-employment and severance benefits as summarized below and further described in "Potential Payments upon Termination or Change in Control." The Compensation Committee believes these benefits are vital to attract and retain qualified executives. These benefits provide the executives with the opportunity to address long-term financial planning with a greater degree of certainty, and also address our interest in continuing to motivate executives in the event of corporate instability, such as a change of control or unforeseen industry changes.

We provide the named executive officers with the opportunity to participate in our Supplemental Executive Retirement Plan, which is a non-qualified defined contribution savings plan. Under the Supplemental Executive Retirement Plan, we provide an annual contribution for each participating executive, a portion of which is based only on the participant's continued service with us, and an additional amount that is dependent on our return on invested capital for the applicable year. Each of these contribution components is referenced as a specified percentage of the executive's base salary and cash incentive award amount for the year. We provide an annual contribution for Messrs. Greiff and Manson based on his continued service with us. They do not receive an additional contribution based on our return on invested capital.

In addition, each of the members of our senior management group, including our named executive officers, also may participate in our Executive Deferred Compensation Plan, a non-qualified voluntary contributory savings plan under which a participant may defer all or any portion of his or her annual incentive award and up to 90% of his or her base salary into one or more investment options that are the same as those available to all of our employees who participate under our 401(k) plan. The Supplemental Executive Retirement Plan and the Executive Deferred Compensation Plan are further described below under the 2016 Non-Qualified Deferred Compensation Table.

To ensure the continuity of corporate management and the continued dedication of key executives during any period of uncertainty caused by a possible change in control, we entered into management retention agreements with each of our named executive officers, except Mr. McNeeley, that provide for the payment and provision of certain benefits if there is a change of control of the Company and a termination of the executive's employment with the surviving entity within a certain period after the change in control. We also have entered into employment agreements with Messrs. Siegal, Wolfort, Marabito, Greiff and McNeeley that provide for the payment of certain severance benefits upon termination of employment other than after a change in control of the Company. These agreements help ensure that our executive's interests remain aligned with those of our shareholders during any time when an executive's continued employment may be in jeopardy. They also provide some level of income continuity should an executive's employment be terminated without cause. In December 2014, we amended the management retention agreements of Messrs. Siegal and Wolfort to eliminate the so-called "walk at will" provision, which provision generally provided the officer with the right, following a change in control of the Company, to terminate the officer's employment with the Company for any reason, or no reason, within the 12-month period commencing with the date of the change in control and still receive certain severance payments and benefits as provided for under the terms of the management retention agreements. These agreements are further described under "Potential Payments upon Termination or Change in Control" below.

Other Compensation Policies

Effect of Section 162(m) of the Internal Revenue Code. Section 162(m) of the Internal Revenue Code denies a publicly held corporation a federal income tax deduction for compensation in excess of $1,000,000 in a taxable year paid to each of its chief executive officer and certain other highly compensated executive officers, other than its chief financial officer. Certain "performance-based" compensation, such as stock options awarded at fair market value, is not subject to the limitation on deductibility provided that certain shareholder approval and independent director requirements are met. To the extent consistent with our compensation policies and the Compensation Committee's assessment of the interests of shareholders, we seek to design our executive compensation programs to preserve our ability to deduct compensation paid to executives under these programs. However, the Compensation Committee also weighs the burdens of such compliance against the benefits to be obtained by us and may pay compensation that is not deductible or fully deductible if it determines that such payments are in our best interests. For example, bonuses paid under our Senior Management Compensation Program historically were not intended to satisfy the requirements for the performance-based compensation exemption from Section 162(m). The Compensation Committee has determined, however, that, to the extent practicable in view of its compensation philosophy, it will seek to structure our cash bonuses to satisfy the requirements for the performance-based exemption from Section 162(m). Therefore, we have adopted the Incentive Plan pursuant to shareholder approval and intend to award future cash bonuses under the plan as we believe that such bonuses paid to executives in accordance with the plan will qualify for the exemption for performance-based compensation.

Section 409A of the Internal Revenue Code. Section 409A of the Internal Revenue Code generally provides that arrangements involving the deferral of compensation that do not comply in form and operation with Section 409A or are not exempt from Section 409A are subject to increased tax, penalties and interest. If a deferred compensation arrangement does not comply with, or is not exempt from, Section 409A, employees may be subject to accelerated or additional tax, or interest or penalties, with respect to the compensation. The Compensation Committee believes that deferred compensation arrangements that do not comply with Section 409A would be of significantly diminished value to our executives. Accordingly, we intend to design our future deferred compensation arrangements, and have amended our previously adopted deferred compensation arrangements, to comply with Section 409A.

Clawback Policy. Although clawbacks are not yet required under the Dodd-Frank Wall Street Reform and Consumer Protection Act, each of our current employment agreements with Messrs. Siegal, Wolfort, Marabito, Greiff and McNeeley includes a provision that requires the named executive officer, in the event we are required to restate our financial statements, to reimburse the Company for the difference between any bonus actually paid and the bonus payable under the restated financial statements. When final regulations are promulgated by the SEC with respect to clawbacks, we expect to implement a formal clawback policy for our named executive officers. The Compensation Committee believes that a clawback policy represents an important protection for shareholders and is viewed favorably from a corporate governance standpoint.

COMPENSATION COMMITTEE REPORT

The Compensation Committee has reviewed and discussed the Compensation Discussion and Analysis with management. Based on this review and discussion, the Compensation Committee recommended to the Board that the Compensation Discussion and Analysis be included in our Annual Report on Form 10-K for the year ended December 31, 2016 and this Proxy Statement.

This report is submitted on behalf of the members of the Compensation Committee:

Howard L. Goldstein, Chairman

Ralph M. Della Ratta

Arthur F. Anton

Michael G. Rippey

Risk Profile of Compensation Programs. The Compensation Committee believes that the Company's executive compensation program has been designed to provide the appropriate level of incentives that do not encourage our executive officers to take unnecessary risks in managing our business. As discussed above, a majority of our executive officers' compensation is performance-based, consistent with our executive compensation policy. Our Senior Management Compensation Program is designed to reward annual financial and/or strategic performance in areas considered critical to the short- and long-term success of the Company. In addition, our Incentive Plan awards are directly aligned with long-term shareholder interests through their link to our stock price and longer-term performance periods. In combination, the Compensation Committee believes that the various elements of the Senior Management Compensation Program and the Incentive Plan sufficiently tie our executives' compensation opportunities to the Company's sustained long-term performance.

COMPENSATION COMMITTEE INTERLOCKS AND INSIDER PARTICIPATION

During 2016, the following individuals served as members of the Compensation Committee: Messrs. Goldstein, Della Ratta, Anton, and Rippey. None of the members of the Compensation Committee during 2016 is (or ever was) an officer or employee of the Company or any of its subsidiaries. There are no Compensation Committee interlocks as defined by applicable SEC rules.

2016 SUMMARY COMPENSATION TABLE

The following table sets forth certain information with respect to the compensation earned during the years ended December 31, 2016, 2015 and 2014 by our Chief Executive Officer, Chief Financial Officer and each of our other named executive officers:

Name and Principal Position	Year	Salary ($)	Bonus ($)	Stock Awards ($)(1)	Option Awards ($)	Non-Equity Incentive Plan Compensation ($)(2)	Change in Pension Value and Nonqualified Deferred Compensation Earnings ($)(3)	All Other Compensation ($)(4)	Total ($)
Michael D. Siegal,	2016	$750,000	$ —	$42,468	$ —	$ —	$ —	$ 161,516	$953,984
Chairman & Chief	2015	$750,000	$ —	$4,720	$ —	$ —	$ —	$ 159,019	$913,739
Executive Officer	2014	$750,000	$ —	$6,835	$ —	$ 223,037	$ —	$ 189,068	$1,168,940
Richard T. Marabito,	2016	$450,000	$ —	$42,468	$ —	$ —	$ —	$ 116,249	$608,717
Chief Financial	2015	$450,000	$ —	$3,500	$ —	$ —	$ —	$ 117,256	$570,756
Officer	2014	$450,000	$ —	$6,835	$ —	$ 223,037	$ —	$ 145,011	$824,883
David A. Wolfort,	2016	$735,000	$ —	$42,468	$ —	$ —	$ —	$ 131,585	$909,053
President	2015	$700,000	$ —	$3,500	$ —	$ —	$ —	$ 131,585	$835,085
	2014	$700,000	$ —	$6,835	$ —	$ 223,037	$ —	$ 161,262	$1,091,134
Donald R. McNeeley,	2016	$625,000	$ —	$3,858	$ —	$ —	$ —	$ 116,219	$745,077
President, CTI	2015	$575,000	$ —	$3,500	$ —	$ —	$ —	$ 114,604	$693,104
	2014	$575,000	$ —	$6,835	$ —	$ —	$ —	$ 143,902	$725,737
Richard A. Manson,	2016	$240,000	$ —	$42,468	$ —	$ —	$ —	$ 70,037	$352,505
Vice President &	2015	$240,000	$ —	$3,500	$ —	$ —	$ —	$ 68,936	$312,436
Treasurer	2014	$212,307	$ —	$6,835	$ —	$ 74,346	$ —	$ 75,517	$369,005
Andrew S. Greiff, EVP & Chief Operating Officer	2016	$385,000	$ —	$42,468	$ —	$ 446,642 (5)	$ —	$ 103,873	$977,983

(1) The amounts shown do not reflect compensation actually received by the named executive officer. The amounts shown in this column are the grant date fair values of the stock awards calculated in accordance with Financial Accounting Standards Board Accounting Standard Codification (ASC) Topic 718. See Note 10 to our consolidated financial statements in our Annual Report on Form 10-K for the year ended December 31, 2016 for details as to the assumptions used to determine the fair value of the stock awards.

(2) Represents amount earned by the named executive officers under our Senior Management Compensation Program. Incentives earned in 2016 were paid in their entirety in 2017.

(3) No above-market or preferential earnings on nonqualified deferred compensation were earned by any named executive officer.

(4) Compensation reported in this column for 2016 includes: (1) the amount of contributions we made on behalf of our named executive officers to our Supplemental Executive Retirement Plan ($97,500 for Mr. Siegal, $58,500 for Mr. Marabito, $95,000 for Mr. Wolfort, $81,250 for Mr. McNeeley, $75,057 for Mr. Greiff and $31,200 for Mr. Manson) and our 401(k) and profit-sharing plan; (2) the premiums we paid for medical, dental, life and disability insurance for each named executive officer; and (3) the incremental cost to us of the following perquisites: country club dues, an allowance for personal tax return preparation fees and a cell phone and an automobile allowance.

(5) Represents Mr. Greiff’s incentive earned as the President of Specialty Metals, the position he held prior to becoming an executive officer.

2016 GRANTS OF PLAN-BASED AWARDS

The following table sets forth plan-based awards granted to our named executive officers during 2016.

Name	Grant Date	Estimated Potential Payouts Under Non-Equity Incentive Plan Awards(1) Threshold ($)	Target ($)	Maximum ($)	Estimated Future Payouts Under Equity Incentive Plan Awards Threshold (#)	Target (#)	Maximum (#)	All Other Stock Awards: Number of Shares of Stock or Units (#)	All Other Option Awards: Number of Securities Underlying Options	Exercise or Base Price of Option Awards	Grant Date Fair Value of Stock and Option Awards ($)(2)
								31,227	14,388	10,853	9,055
Stockholders' equity	377,277	357,036	354,334	362,750		274,873	206,930				
Other Operating Data:											
Billed lives	36,000	32,900	31,700	27,400		2,426	1,883				
Annualized revenue in backlog	$ 32,400	$ 35,900	$ 13,600	$ 39,900	$	6,625	$ 32,578				

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

(2)

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

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operation

Overview

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Change in Fiscal Year

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

Forward-Looking Statements

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

- our ability to sign and implement new contracts for our solutions;
- our ability to retain existing customers and to renew or maintain contracts with our customers under existing terms or restructure these contracts on terms that would not have a material negative impact on our results of operations;

- our ability to accurately forecast performance and the timing of revenue recognition under the terms of our customer contracts ahead of data collection and reconciliation in order to provide forward-looking guidance;
- the impact of national healthcare reform proposals and the potential impact of healthcare reform legislation, if enacted, on our operations and/or the demand for our services;
- the impact of any new or proposed legislation, regulations and interpretations relating to the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, including the potential expansion to Phase II for Medicare Health Support programs and any legislative or regulatory changes with respect to Medicare Advantage;
- our ability to reach mutual agreement with the Centers for Medicare & Medicaid Services ("CMS") with respect to results under Phase I of Medicare Health Support;
- our ability to anticipate the rate of market acceptance of our solutions in potential international markets;
- our ability to accurately forecast the costs necessary to implement our strategy of establishing a presence in international markets;
- the risks associated with foreign currency exchange rate fluctuations and our ability to hedge against such fluctuations;
- the risks associated with a significant concentration of our revenues with a limited number of customers;
- our ability to effect cost savings and clinical outcomes improvements under our contracts and reach mutual agreement with customers with respect to cost savings, or to effect such savings and improvements within the time frames contemplated by us;
- our ability to achieve estimated annualized revenue in backlog in the manner and within the 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 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 and make principal and interest payments as those payments become due;
- the risks associated with changes in macroeconomic conditions, which may reduce the demand and/or the timing of purchases for our services from customers or potential customers, reduce the number of covered lives of our existing customers, restrict our ability to obtain additional financing, or impact the availability of credit under our Third Amended Credit Agreement;
- counterparty risk associated with our interest rate swap agreements and foreign currency exchange contracts;
- our ability to integrate acquired businesses or technologies into our business;
- the impact of any impairment of our goodwill or other intangible assets;
- our ability to develop new products and deliver outcomes on those products;
- our ability to implement our new integrated data and technology solutions platform within the timeframe and cost estimates that we expect;
- our ability to obtain adequate financing to provide the capital that may be necessary to support our operations and to support or guarantee our performance under new contracts;
- unusual and unforeseen patterns of healthcare utilization by individuals with diabetes, cardiac, respiratory and/or other diseases or conditions for which we provide services;
- the ability of our customers to maintain the number of covered lives enrolled in the plans during the terms of our agreements;
- the impact of litigation involving us and/or our subsidiaries;

- the impact of future state, federal, and international healthcare and other applicable legislation and regulations on our ability to deliver our services and on the financial health of our customers and their willingness to purchase our services;
- current geopolitical turmoil, the continuing threat of domestic or international terrorism, and the potential emergence of a health pandemic; and
- other risks detailed in this Annual Report on Form 10-K, including those set forth in Item 1A.

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

Critical Accounting Policies

We describe our accounting policies in Note 1 of the Notes to the Consolidated Financial Statements. We prepare the consolidated financial statements in conformity with U.S. GAAP, which requires us to make estimates and judgments that affect the reported amounts of assets and liabilities and related disclosures at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results may differ from those estimates.

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

Revenue Recognition

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

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

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

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

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

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

In 2005, we began participating in two Medicare Health Support pilots, which concluded in January 2008 and July 2008, respectively. Substantially all of the fees under these pilots were performance-based. Our original cooperative agreements required that, by the end of the third year, we achieve a cumulative net savings (total savings for the intervention population as compared to the control group less fees received from CMS) of 5.0%. Under an amendment to our agreement for our stand-alone Medicare Health Support pilot in Maryland and the District of Columbia, we began serving a "refresh population" of approximately 4,500 beneficiaries on August 1, 2006, which was measured as a separate cohort for two years, by the end of which the program was required to achieve a 2.5% cumulative net savings when compared to a new control cohort. In April 2008, we signed an amendment to our Medicare Health Support protocol with CMS, which changed the financial performance target for both the initial and the refresh populations to budget neutrality. In late April 2009, we received the final reconciliation report from CMS' independent financial reconciliation contractor. Based upon this final reconciliation report as well as our performance over the term of the pilots, we have recognized $9.5 million of cumulative performance-based fees related to these pilots and $12.2 million of fixed fees. At December 31, 2009, approximately $57.8 million of performance-based fees related to these pilots was recorded in contract billings in excess of earned revenue, $50.3 million of which related to fees collected, and the remaining $7.5 million of which related to fees billed but not collected due to CMS withholding payment of these fees. We submitted our objections to the final reconciliation report and engaged in discussions with CMS regarding our objections. We, along with several other participating organizations in the Medicare Health Support pilots, have submitted a proposal to CMS to resolve the issues related to the reconciliation; however, such proposal remains subject to approval by the United States government.

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

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

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

Impairment of Intangible Assets and Goodwill

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

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

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

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

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

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

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

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

Income Taxes

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

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

Share-Based Compensation

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

Business Strategy

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

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

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

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

We believe it is critical to impact an entire population's underlying health status and well-being in a long-term, cost effective way. Believing that what gets measured gets acted upon, in January 2008, we entered into an exclusive, 25-year relationship with Gallup to provide a national, daily pulse of individual and collective well-being. The Gallup-Healthways Well-Being IndexTM is a unique partnership in well-being

measurement and research that is based on surveys of 1,000 Americans every day, seven days a week. Under the agreement, Gallup evaluates and reports on the well-being of individuals of countries, states and communities; Healthways provides similar services for companies, families and individuals.

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

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

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

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

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

Results of Operations

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

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

(1) Figures may not add due to rounding.

Revenues

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

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

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

- the commencement of contracts with new customers;
- increased revenues from fitness center programs, primarily due to an increase in participation in these programs as well as in the number of members eligible for them;

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- growth in the number of self-insured employer lives under existing customer contracts;
- increased performance-based revenues due to our ability to measure and achieve performance targets on certain contracts during fiscal 2009; and
- increased membership in customers' existing programs.

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

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

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

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

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

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

Cost of Services

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

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

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

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

- cost savings related to certain cost management initiatives.

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

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

- the completion of an offer to purchase from our employees, excluding the chief executive officer and Board of Directors, outstanding options to acquire shares of common stock of the Company that were granted between September 1, 2004 and August 15, 2008 under our shareholder-approved stock option plans (the "Tender Offer") on December 30, 2008. The Tender Offer resulted in additional stock-based compensation expense within cost of services of $7.4 million, representing the remaining compensation cost for these options as measured at the grant date but not yet recognized prior to the completion of the Tender Offer;
- increased member utilization of fitness centers for contracts for which we receive a fixed fee per member;
- contract restructurings with certain customers, as noted above, that resulted in decreased revenues without a proportional corresponding decrease in costs; and
- increased costs related to information technology hosting security and storage for the four months ended December 31, 2008.

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

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

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

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

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

Selling, General and Administrative Expenses

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

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

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

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

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

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

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

Depreciation and Amortization

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

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

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

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

Restructuring and Related Charges and Impairment Loss

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

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

Gain on Sale of Investment

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

Interest Expense

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

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

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

Legal Settlement and Related Costs

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

Income Tax Expense

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

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

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

Outlook

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

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

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

Liquidity and Capital Resources

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Contractual Obligations

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

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

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

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

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

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

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

Recently Issued Accounting Standards

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

In May 2009, the FASB issued guidance which establishes accounting and disclosure requirements for subsequent events. The guidance defines subsequent events as events that occur after the balance sheet date but before the financial statements are issued for public entities. It requires companies to disclose the date through which they have evaluated subsequent events and to designate subsequent events as either recognized or non-recognized. In February 2010, the FASB issued revised guidance, effectively immediately for all financial statements that had not yet been issued, to remove the requirement for SEC filers to disclose the date

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through which they have evaluated subsequent events. The original guidance became effective for interim or annual periods ending after June 15, 2009. The implementation of this guidance, as revised, resulted in increased disclosures but did not have an impact on our financial position or results of operations.

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

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

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

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

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

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

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

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders of Healthways, Inc.

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

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

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

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

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

/s/ Ernst & Young LLP

Nashville, Tennessee
March 16, 2010

Item 8. Financial Statements and Supplementary Data

HEALTHWAYS, INC.
CONSOLIDATED BALANCE SHEETS
(In thousands)

ASSETS

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

See accompanying notes to the consolidated financial statements.

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HEALTHWAYS, INC.
CONSOLIDATED BALANCE SHEETS
(In thousands, except share and per share data)

LIABILITIES AND STOCKHOLDERS' EQUITY

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

See accompanying notes to the consolidated financial statements.

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

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

See accompanying notes to the consolidated financial statements.

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HEALTHWAYS, INC.
CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY
(In thousands)

	Preferred Stock	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
Balance, August 31, 2006	$—	$35	$140,200	$134,622	$16	$274,873
Comprehensive income:						
Net income	—	—	—	45,121	—	45,121
Net change in fair value of interest rate swap, net of income tax benefit of $133	—	—	—	—	(205)	(205)
Foreign currency translation adjustment	—	—	—	—	137	137
Total comprehensive income						45,053
Sale of unregistered common stock	—	—	5,000	—	—	5,000
Repurchases of common stock	—	—	(552)	(5,102)	—	(5,654)
Exercise of stock options and other	—	—	11,221	—	—	11,221
Tax benefit of option exercises	—	—	13,421	—	—	13,421
Share-based employee compensation expense	—	—	18,836	—	—	18,836
Balance, August 31, 2007	$—	$35	$188,126	$174,641	$(52)	$362,750
Cumulative effect of a change in accounting principle – adoption of FIN 48	—		—	(687)	—	(687)
Comprehensive income:						
Net income	—	—	—	54,815	—	54,815
Net change in fair value of interest rate swap, net of income tax benefit of $1,064	—	—	—	—	(1,510)	(1,510)
Foreign currency translation adjustment	—	—	—	—	172	172
Total comprehensive income						53,477
Repurchases of common stock	—	(2)	(13,341)	(80,997)	—	(94,340)
Exercise of stock options and other	—	1	6,710	—	—	6,711
Tax benefit of option exercises	—	—	9,893	—	—	9,893
Share-based employee compensation expense	—	—	16,530	—	—	16,530
Balance, August 31, 2008	$—	$34	$207,918	$147,772	$(1,390)	$354,334
Comprehensive income:						
Net income	—	—	—	734	—	734

Net change in fair value of interest rate swaps, net of income tax benefit of $3,371	—	—	—	—	(5,007)	(5,007)
Change in fair value of investment, net of income taxes of $1,094	—	—	—	—	1,607	1,607
Foreign currency translation adjustment	—	—	—	—	(175)	(175)
Total comprehensive loss						(2,841)
Write-off of deferred tax assets related to the repurchase of stock options	—	—	(9,088)	—	—	(9,088)
Exercise of stock options	—	—	56	—	—	56
Tax effect of option exercises	—	—	(340)	—	—	(340)
Share-based employee compensation expense	—	—	14,915	—	—	14,915
Balance, December 31, 2008	$—	$34	$213,461	$148,506	$(4,965)	$357,036
Comprehensive income:						
Net income	—	—	—	10,374	—	10,374
Net change in fair value of interest rate swaps, net of income taxes of $1,783	—	—	—	—	2,418	2,418
Change in fair value of investment, net of income tax benefit of $49	—	—	—	—	(71)	(71)
Sale of investment, net of income taxes of $1,045	—	—	—	—	(1,536)	(1,536)
Foreign currency translation adjustment	—	—	—	—	45	45
Total comprehensive income						11,230
Repurchase of stock options	—	—	(736)	—	—	(736)
Exercise of stock options	—	—	727	—	—	727
Tax effect of option exercises	—	—	(1,193)	—	—	(1,193)
Share-based employee compensation expense	—	—	10,213	—	—	10,213
Balance, December 31, 2009	$—	$34	$222,472	$158,880	$(4,109)	$377,277

See accompanying notes to the consolidated financial statements.

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

	Year Ended December 31, 2009	Four Months Ended December 31, 2008	Year Ended August 31, 2008	2007
Cash flows from operating activities:				
Net income	$ 10,374	$ 734	$ 54,815	$ 45,121
Adjustments to reconcile net income to net cash provided by operating activities, net of business acquisitions:				
Depreciation and amortization	49,289	16,188	47,479	37,044
Gain on sale of investment	(2,581)	-	-	-
Loss on disposal of property and equipment	1,584	1,568	-	-
Impairment loss	-	4,344	-	-
Amortization of deferred loan costs	1,518	415	1,168	991
Share-based employee compensation expense	10,213	14,915	16,530	18,836
Excess tax benefits from share-based payment arrangements	(381)	(68)	(9,480)	(12,152)
Decrease (increase) in accounts receivable, net	14,352	(1,796)	(33,131)	(2,749)
(Increase) decrease in other current assets	(1,972)	(3,011)	3,927	(3,299)
Increase (decrease) in accounts payable	6,565	(3,620)	2,516	(1,143)
Increase (decrease) in accrued salaries and benefits	24,991	1,549	12,652	(21,362)
(Decrease) increase in other current liabilities	(11,067)	3,374	11,491	52,227
Deferred income taxes	8,076	(14,133)	(10,835)	(10,866)
Other	6,049	1,672	11,761	5,092
(Increase) decrease in other assets	(172)	540	(1,367)	834
	(3,970)	(504)	(2,220)	(1,247)

Payments on other long-term liabilities				
Net cash flows provided by operating activities	112,868	22,167	105,306	107,327
Cash flows from investing activities:				
Acquisition of property and equipment	(49,110)	(13,753)	(82,521)	(29,507)
Sale of investment	11,626	-	-	-
Business acquisitions, net of cash acquired, and equity investments	(19,486)	(449)	-	-
Change in restricted cash	(538)	-	(452)	(493,071)
Purchase of investment	-	-	-	(9,045)
Other	(4,918)	(2,208)	(3,690)	(13)
Net cash flows used in investing activities	(62,426)	(16,410)	(86,663)	(531,636)
Cash flows from financing activities:				
Proceeds from issuance of long-term debt	405,400	55,000	85,420	350,000
Deferred loan costs	(784)	(290)	-	(4,357)
Proceeds from sale of unregistered common stock	-	-	-	5,000
Repurchases of common stock	-	-	(94,340)	(5,654)
Repurchase of stock options	(736)	-	-	-
Excess tax benefits from share-based payment arrangements	381	68	9,480	12,152
Exercise of stock options	727	56	6,711	11,221
Payments of long-term debt	(457,303)	(96,825)	(38,327)	(51,190)
Change in outstanding checks and other	(1,113)	6,149	-	-
Net cash flows (used in) provided by financing activities	(53,428)	(35,842)	(31,056)	317,172
Effect of exchange rate changes on cash	185	-	-	-
Net decrease in cash and cash equivalents	(2,801)	(30,085)	(12,413)	(107,137)

Cash and cash equivalents, beginning of period		5,157	35,242	47,655	154,792
Cash and cash equivalents, end of period	$	2,356	5,157	35,242	47,655
Supplemental disclosure of cash flow information:					
Cash paid during the period for interest	$	12,717	8,297	19,117	14,042
Cash paid during the period for income taxes	$	18,390	10,914	41,249	38,580

See accompanying notes to the consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Year Ended December 31, 2009, Four Months Ended December 31, 2008, and Years Ended August 31, 2008 and 2007

1. Summary of Significant Accounting Policies

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

In 2005, we began participating in two Medicare Health Support pilots, which concluded in January 2008 and July 2008, respectively. Substantially all of the fees under these pilots were performance-based. Our original cooperative agreements required that, by the end of the third year, we achieve a cumulative net savings (total savings for the intervention population as compared to the control group less fees received from the Centers for Medicare & Medicaid Services ("CMS")) of 5.0%. Under an amendment to our agreement for our stand-alone Medicare Health Support pilot in Maryland and the District of Columbia, we began serving a "refresh population" of approximately 4,500 beneficiaries on August 1, 2006, which was measured as a separate cohort for two years, by the end of which the program was required to achieve a 2.5% cumulative net savings when compared to a new control cohort. In April 2008, we signed an amendment to our Medicare Health Support protocol with CMS, which changed the financial performance target for both the initial and the refresh populations to budget neutrality. In late April 2009, we received the final reconciliation report from CMS' independent financial reconciliation contractor. Based upon this final reconciliation report as well as our performance over the term of the pilots, we have recognized $9.5 million of cumulative performance-based fees related to these pilots and $12.2 million of fixed fees. At December 31, 2009, approximately $57.8 million of performance-based fees related to these pilots was recorded in contract billings in excess of earned revenue, $50.3 million of which related to fees collected, and the remaining $7.5 million of which related to fees billed but not collected due to CMS withholding payment of these fees. We submitted our objections to the final reconciliation report and engaged in discussions with CMS regarding our objections. We, along with several other participating organizations in the Medicare Health Support pilots, have submitted a proposal to CMS to resolve the issues related to the reconciliation; however, such proposal remains subject to approval by the United States government.

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

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

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

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

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

m. Derivative Instruments and Hedging Activities – We record all derivatives at estimated fair value as either assets or liabilities on the balance sheet and recognize the unrealized gains and losses in either the balance sheet or statement of operations, depending on whether the derivative is designated as a hedging instrument. As permitted under our master netting arrangements, beginning September 30, 2009, the fair value amounts of our derivative instruments are presented on a net basis by counterparty in the consolidated balance sheet. See Note 6 for further information.

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

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

2. Recently Issued Accounting Standards

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

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

In June 2009, the FASB approved the FASB Accounting Standards Codification (the "Codification"). Effective July 1, 2009, the Codification is the single source of authoritative nongovernmental

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

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

3. Goodwill

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

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

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

4. Intangible Assets

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

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

Total	$	126,597	$	55,500	$	71,097

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

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

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

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

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

5. Income Taxes

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

(In $000s)	Year Ended December 31, 2009	Four Months Ended December 31, 2008	Year Ended August 31, 2008	Year Ended August 31, 2007
Current taxes				
Federal	$ 835	$ 11,946	$ 47,147	$ 34,187
State	754	2,827	9,569	6,465
Deferred taxes				
Federal	7,638	(11,308)	(15,500)	(8,618)

State		910		(2,456)		(3,476)		(1,871)
Total	$	10,137	$	1,009	$	37,740	$	30,163

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

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

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

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

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

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

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

Uncertain Tax Positions

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

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

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

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

6. Derivative Instruments and Hedging Activities

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

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Interest Rate

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

Foreign Currency

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

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

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

See also Note 7.

Cash Flow Hedges

Derivative instruments that are designated and qualify as cash flow hedges are recorded at estimated fair value in the balance sheet, with the effective portion of the gains and losses being reported in other comprehensive income (“OCI”) or loss. These gains and losses are reclassified into earnings in the same period during which the hedged transaction affects earnings or the period in which all or a portion of the hedge

becomes ineffective. As of December 31, 2009, we expect to reclassify $5.2 million of net losses on interest rate swap agreements from accumulated OCI to interest expense within the next 12 months due to the scheduled payment of interest associated with floating rate debt.

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

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

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

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

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

Year Ended December 31, 2009		
Amount of Gain (Loss)	Location of Gain (Loss) Reclassified	Amount of Gain (Loss)

Derivatives in Cash Flow Hedging Relationships	Recognized in OCI on Derivatives (Effective Portion)	from Accumulated OCI into Income (Effective Portion)	Reclassified from Accumulated OCI into Income (Effective Portion)
Interest rate swap agreements, gross of tax effect	$(2,541)	Interest expense	$(6,742)

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

Derivative Instruments Not Designated as Hedging Instruments

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

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

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

7. Fair Value Measurements

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

Fair Value Hierarchy

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

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

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

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

Assets and Liabilities Measured at Fair Value on a Recurring Basis

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

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

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

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

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

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

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

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

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

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

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

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

Fair Value of Other Financial Instruments

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

- Cash and cash equivalents – The carrying amount of $2.4 million approximates fair value because of the short maturity of those instruments (less than three months).

- Long-term debt –The estimated fair value of outstanding borrowings under the Third Amended Credit Agreement is based on the average of the prices set by the issuing bank given current market conditions and is not necessarily indicative of the amount we could realize in a current market exchange. The estimated fair value and carrying amount of outstanding borrowings under the Third Amended Credit Agreement at December 31, 2009 are $239.8 million and $256.0 million, respectively.

8. Long-Term Debt

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

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

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

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

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

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

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

9. Other Long-Term Liabilities

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

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

10. Restructuring and Related Charges and Impairment Loss

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

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

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

(In 000s)

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

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

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

11. Commitments and Contingencies

Former Employee Action

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

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

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

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

Securities Class Action Litigation

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

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

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

Shareholder Derivative Lawsuits

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

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

ERISA Lawsuits

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

An amended complaint was filed on September 29, 2008, naming as defendants the Company, the Board of Directors, certain officers, and members of the Investment Committee charged with administering the 401(k) plan. The amended complaint alleged that the defendants violated ERISA by failing to remove the Company stock fund from the

401(k) plan when it allegedly became an imprudent investment, by failing to

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disclose adequately the risks and results of the MHS pilot program to 401(k) plan participants, and by failing to seek independent advice as to whether to continue to permit the plan to hold Company stock. It further alleged that the Company and its directors should have been more closely monitoring the Investment Committee and other plan fiduciaries. The amended complaint sought damages in an undisclosed amount and other equitable relief. The defendants filed a motion to dismiss on October 29, 2008. On January 28, 2009, the Court granted the defendants' motion to dismiss the plaintiff's claims for breach of the duty to disclose with regard to any non-public information and information beyond the specific disclosure requirements of ERISA and denied Defendants' motion to dismiss as to the remainder of the plaintiff's claims. A period of discovery ensued.

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

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

Outlook

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

Contractual Commitment

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

12. Leases

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

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various dates from 2010 to 2015. Our operations support and training offices contain approximately 130,000 square feet in aggregate and have lease terms expiring from 2010 to 2016.

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

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

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

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

13. Share-Based Compensation

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

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

On December 30, 2008, we completed an offer to purchase from our employees, excluding the chief executive officer and Board of Directors, outstanding options to acquire shares of common stock of the Company that were granted between September 1, 2004 and August 15, 2008 under our shareholder-approved stock option plans (the "Tender

Offer”). We purchased stock options representing the right to acquire 1.1 million shares of the Company’s common stock in exchange for $0.7 million in cash. We also recognized

$11.5 million of additional stock-based compensation expense in December 2008, which represented the remaining compensation cost for these options as measured at the grant date but not yet recognized prior to the completion of the Tender Offer on December 30, 2008.

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

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

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

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

Stock Options

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

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

	Year Ended December 31, 2009	Four Months Ended December 31, 2008	Year Ended August 31, 2008	Year Ended August 31, 2007
Weighted average grant-date fair value of options	$ 6.72	$ 4.97	$ 22.16	$ 22.08

Assumptions:				
Expected volatility	51.6%	46.5%	37.8%	48.7%
Expected dividends	—	—	—	—
Expected term (in years)	6.1	5.1	6.6	5.5
Risk-free rate	2.5%	3.6%	4.2%	5.1%

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

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

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

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

Restricted Stock and Restricted Stock Units

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

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

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

14. Sale of Investment

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

15. Comprehensive Income

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

16. Earnings Per Share

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

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

17. Unaudited Financial Information

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

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

(In 000s)		Four Months Ended December 31, 2007
Cash flows from operating activities:		
Net income	$	16,480
Adjustments to reconcile net income to net cash provided by operating activities, net of business acquisitions:		
Depreciation and amortization		13,682
Loss on disposal of property and equipment		221
Amortization of deferred loan costs		389
Share-based employee compensation expense		5,057
Excess tax benefits from share-based payment arrangements		(6,072)
Increase in accounts receivable, net		(12,084)
Decrease in other current assets		1,513
Decrease in accounts payable		(2,429)
Increase in accrued salaries and benefits		1,848
Increase in other current liabilities		10,257
Deferred income taxes		(3,025)
Other		3,951
Decrease in other assets		303
Payments on other long-term liabilities		(111)
Net cash flows provided by operating activities		29,980
Cash flows from investing activities:		
Acquisition of property and equipment		(25,045)
Acquisitions, net of cash acquired		(15)
Net cash flows used in investing activities		(25,060)
Cash flows from financing activities:		
Repurchases of common stock		(132)
Excess tax benefits from share-based payment arrangements		6,072
Exercise of stock options		3,070
Payments of long-term debt		(21,070)
Net cash flows used in financing activities		(12,060)
Net decrease in cash and cash equivalents		(7,140)
Cash and cash equivalents, beginning of period		47,655
Cash and cash equivalents, end of period	$	40,515

18. Stockholder Rights Plan

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

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

19. Employee Benefits

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

20. Segment Disclosures

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

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

21. Quarterly Financial Information (unaudited)

(In thousands, except per share data)								
Twelve Months Ended December 31, 2009		First (1)		Second		Third		Fourth
Revenues	$	182,736	$	177,836	$	181,642	$	175,212
Gross margin	$	41,112	$	41,534	$	40,627	$	35,720
Income (loss) before income taxes	$	(22,572)	$	15,534	$	15,484	$	12,065
Net income (loss)	$	(14,813)	$	8,876	$	8,802	$	7,509
Basic earnings (loss) per share (2)	$	(0.44)	$	0.26	$	0.26	$	0.22
Diluted earnings (loss) per share (2)	$	(0.44)(3)	$	0.26	$	0.26	$	0.22
Twelve Months Ended December 31, 2008		First		Second		Third		Fourth (4)
Revenues	$	180,940	$	193,044	$	187,448	$	185,272
Gross margin	$	44,324	$	55,604	$	52,504	$	40,438
Income (loss) before income taxes	$	17,366	$	27,673	$	26,012	$	(4,744)
Net income (loss)	$	10,203	$	16,325	$	15,623	$	(3,087)
Basic earnings (loss) per share (2)	$	0.28	$	0.48	$	0.46	$	(0.09)
Diluted earnings (loss) per share (2)	$	0.27	$	0.46	$	0.45	$	(0.09)(3)

(1) Includes a legal settlement of approximately $40.0 million.

(2) We calculated earnings per share for each of the quarters based on the weighted average number of shares and dilutive options outstanding for each period. Accordingly, the sum of the quarters may not necessarily be equal to the full year income per share.

(3) The assumed exercise of stock-based compensation awards for this period was not considered because the impact would have been anti-dilutive.

(4) Includes restructuring and impairment charges of approximately $14.6 million.

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders of Healthways, Inc.

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

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

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

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

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

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

/s/ Ernst & Young LLP

Nashville, Tennessee
March 16, 2010

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Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

Not applicable.

Item 9A. Controls and Procedures

Management's Annual Report on Internal Control over Financial Reporting

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

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

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

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

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

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

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Item 9B. Other Information

Not applicable.

PART III

Item 10. Directors, Executive Officers and Corporate Governance

Information concerning our directors, audit committee, audit committee financial experts, code of ethics, and compliance with Section 16(a) of the Exchange Act will be included in our Proxy Statement for the Annual Meeting of Stockholders to be held May 28, 2010, to be filed with the Securities and Exchange Commission pursuant to Rule 14a-6(c), and is incorporated herein by reference.

Pursuant to General Instruction G(3), information concerning our executive officers is included in Part I of this Annual Report on Form 10-K, under the caption "Executive Officers of the Registrant."

Item 11. Executive Compensation

Information required by this item will be contained in our Proxy Statement for the Annual Meeting of Stockholders to be held May 28, 2010, to be filed with the Securities and Exchange Commission pursuant to Rule 14a-6(c), and is incorporated herein by reference.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

Except as set forth below, information required by this item will be contained in our Proxy Statement for the Annual Meeting of Stockholders to be held May 28, 2010, to be filed with the Securities and Exchange Commission pursuant to Rule 14a-6(c), and is incorporated herein by reference.

Item 13. Certain Relationships and Related Transactions, and Director Independence

Information required by this item will be contained in our Proxy Statement for the Annual Meeting of Stockholders to be held May 28, 2010, to be filed with the Securities and Exchange Commission pursuant to Rule 14a-6(c), and is incorporated herein by reference.

Item 14. Principal Accountant Fees and Services

Information required by this item will be contained in our Proxy Statement for the Annual Meeting of Stockholders to be held May 28, 2010, to be filed with the Securities and Exchange Commission pursuant to Rule 14a-6(c), and is incorporated herein by reference.

PART IV

Item 15. Exhibits, Financial Statement Schedules

(a) The following documents are filed as part of this Annual Report on Form 10-K:

1. The financial statements filed as part of this report are included in Part II, Item 8 of this Annual Report on Form 10-K.

2. We have omitted all Financial Statement Schedules because they are not required under the instructions to the applicable accounting regulations of the Securities and Exchange Commission or the information to be set forth therein is included in the financial statements or in the notes thereto.

3. Exhibits

2.1 Stock Purchase Agreement dated October 11, 2006 among Healthways, Inc., Axia Health Management, Inc., and Axia Health Management LLC [incorporated herein by reference to Exhibit 2.1 to the Company's Current Report on Form 8-K dated December 1, 2006]

3.1 Restated Certificate of Incorporation for Healthways, Inc., as amended [incorporated by reference to Exhibit 3.1 to Form 10-Q of the Company's fiscal quarter ended February 29, 2008]

3.2 Bylaws, as amended [incorporated by reference to Exhibit 3.1 to Form 10-Q of the Company's fiscal quarter ended February 29, 2004]

3.3 Amendment to bylaws, as amended [incorporated by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K dated November 15, 2007]

3.4 Amendment No. 2 to bylaws, as amended [incorporated by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K dated September 3, 2008]

4.1 Article IV of the Company's Restated Certificate of Incorporation (included in Exhibit 3.1)

4.2 Rights Agreement, dated June 19, 2000, between American Healthways, Inc. and SunTrust Bank, including the Form of Rights Certificate (Exhibit A), the Form of Summary of Rights (Exhibit B) and the Form of Certificate of Amendment to the Restated Certificate of Incorporation of American Healthways, Inc. (Exhibit C) [incorporated herein by reference to Exhibit 4 to the Company's Current Report on Form 8-K dated June 21, 2000]

4.3 Amendment No. 1 to Rights Agreement, dated June 15, 2004, between American Healthways, Inc. and SunTrust Bank [incorporated herein by reference to Exhibit 4 to the Company's Current Report on Form 8-K dated June 17, 2004]

4.4 Amendment No. 2 to Rights Agreement, dated July 19, 2006, between Healthways, Inc. and SunTrust Bank [incorporated herein by reference to Exhibit 4.1 to the Company's Current Report on Form 8-K dated July 19, 2006]

10.1 Third Amended and Restated Revolving Credit and Term Loan Agreement ("Third Amended Credit Agreement") between the Company and SunTrust Bank as Administrative Agent, U.S. Bank National Association and Regions Bank as Co-Documentation

Agents, and JPMorgan Chase Bank, N.A., and Fifth Third Bank, N.A. as Co-Syndication Agents dated December 1, 2006 [incorporated by reference to Exhibit 10.1 to Form 10-Q of the Company's fiscal quarter ended November 30, 2006]

10.2	First Amendment to Third Amended Credit Agreement, dated February 20, 2007 by and among the Company, various lenders, and SunTrust Bank, as Administrative Agent, Issuing Bank and Swingline Lender [incorporated by reference to Exhibit 10.1 to Form 10-Q of the Company's fiscal quarter ended February 28, 2007]
10.3	Second Amendment to Third Amended Credit Agreement, dated April 11, 2007 by and among the Company, various lenders, and SunTrust Bank, as Administrative Agent, Issuing Bank and Swingline Lender [incorporated by reference to Exhibit 10.1 to Form 10-Q of the Company's fiscal quarter ended May 31, 2007]
10.4	Third Amendment to Third Amended Credit Agreement, dated July 16, 2007 by and among the Company, various lenders, and SunTrust Bank, as Administrative Agent, Issuing Bank and Swingline Lender [incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K dated July 18, 2007]
10.5	Fourth Amendment to Third Amended Credit Agreement, dated August 15, 2008 by and among the Company, various lenders, and SunTrust Bank, as Administrative Agent, Issuing Bank and Swingline Lender [incorporated by reference to Exhibit 10.5 to Form 10-K of the Company's fiscal year ended August 31, 2008]
10.6	Fifth Amendment to Third Amended Credit Agreement, dated August 22, 2008 by and among the Company, various lenders, and SunTrust Bank, as Administrative Agent, Issuing Bank and Swingline Lender [incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K dated August 25, 2008]
10.7	Sixth Amendment to Third Amended Credit Agreement, dated March 5, 2009 by and among the Company, various lenders, and SunTrust Bank, as Administrative Agent, Issuing Bank and Swingline Lender [incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K dated March 13, 2009]
10.8	Office Lease by and between Healthways, Inc. and Highwoods/Tennessee Holdings, L.P., dated as of May 4, 2006 [incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K dated May 5, 2006]
10.9	Consulting Agreement between the Company and Rincon Advisors, LLC dated October 11, 2006 [incorporated by reference to Exhibit 10.2 to Form 10-Q of the Company's fiscal quarter ended November 30, 2006]

10.10	Subscription Agreement between the Company, L. Ben Lytle, and the L. Ben Lytle Amended and Restated Revocable Living Trust, U/A dated October 11, 2006 [incorporated by reference to Exhibit 10.3 to Form 10-Q of the Company's fiscal quarter ended November 30, 2006]

Management Contracts and Compensatory Plans

10.11	Employment Agreement dated December 19, 2008 between the Company and Ben R. Leedle [incorporated by reference to Exhibit 10.1 to the Company's Form 10-QT of the Company's transition period ended December 31, 2008]
10.12	Employment Agreement dated December 19, 2008 between the Company and Mary A. Chaput [incorporated by reference to Exhibit 10.2 to the Company's Form 10-QT of the Company's transition period ended December 31, 2008]
10.13	Employment Agreement dated December 19, 2008 between the Company and Anne Wilkins [incorporated by reference to Exhibit 10.3 to Form 10-QT of the Company's transition period ended December 31, 2008]
10.14	Employment Agreement dated December 10, 2008 between the Company and Matthew Kelliher [incorporated by reference to Exhibit 10.4 to Form 10-QT of the Company's transition period ended December 31, 2008]
10.15	Employment Agreement dated October 11, 2008 between the Company and Stefen F. Brueckner [incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K dated October 16, 2008]
10.16	Employment Agreement dated January 7, 2009 between the Company and Alfred Lumsdaine [incorporated by reference to Exhibit 10.5 to Form 10-QT of the Company's transition period ended December 31, 2008]
10.17	Employment Agreement dated January 7, 2009 between the Company and Chris Cigarran
10.18	Employment Agreement dated January 7, 2009 between the Company and R. Claiborne Richards, Jr.
10.19	Long-term performance award agreement dated September 28, 2006 between the Company and Matthew E. Kelliher [incorporated by reference to Exhibit 10.2 to Form 10-Q of the Company's fiscal quarter ended February 28, 2007]
10.20	Capital Accumulation Plan, as amended and restated [incorporated by reference to Exhibit 10.1 to Form 10-Q of the Company's fiscal quarter ended November 30, 2008]
10.21	

	Form of Indemnification Agreement by and among the Company and the Company's directors [incorporated by reference to Exhibit 10.15 to Registration Statement on Form S-1 (Registration No. 33-41119)]
10.22	2007 Stock Incentive Plan [incorporated by reference to Exhibit 10.1 to the Company’s Current Report on Form 8-K dated February 8, 2007]

10.23	1996 Stock Incentive Plan, as amended [incorporated by reference to Exhibit 10.20 to Form 10-K of the Company's fiscal year ended August 31, 2006]
10.24	2001 Amended and Restated Stock Option Plan, as amended [incorporated by reference to Exhibit 10.21 to Form 10-K of the Company's fiscal year ended August 31, 2006]
10.25	Form of Non-Qualified Stock Option Agreement under the Company's 2007 Stock Incentive Plan [incorporated by reference to Exhibit 10.24 to Form 10-K of the Company's fiscal year ended August 31, 2007]
10.26	Form of Restricted Stock Unit Award Agreement under the Company's 2007 Stock Incentive Plan [incorporated by reference to Exhibit 10.25 to Form 10-K of the Company's fiscal year ended August 31, 2007]
10.27	Form of Non-Qualified Stock Option Agreement (for Directors) under the Company's 2007 Stock Incentive Plan [incorporated by reference to Exhibit 10.30 to Form 10-K of the Company's fiscal year ended August 31, 2008]
10.28	2007 Stock Incentive Plan Performance Cash Award Agreement Company's [incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K dated March 4, 2009]
21	Subsidiary List
23	Consent of Ernst & Young LLP
31.1	Certification pursuant to section 302 of the Sarbanes-Oxley Act of 2002 made by Ben R. Leedle, Jr., Chief Executive Officer
31.2	Certification pursuant to section 302 of the Sarbanes-Oxley Act of 2002 made by Mary A. Chaput, Chief Financial Officer
32	Certification Pursuant to 18 U.S.C section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 made by Ben R. Leedle, Jr., Chief Executive Officer and Mary A. Chaput, Chief Financial Officer

(b) Exhibits

Refer to Item 15(a)(3) above.

(c) Not applicable

SIGNATURES

Pursuant to the requirements of section 13 or 15(d) 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.

HEALTHWAYS, INC

March 16, 2010	By:	/s/ Ben R. Leedle, Jr. Ben R. Leedle, Jr. Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

Signature	Title	Date
/s/ Ben R. Leedle, Jr. Ben R. Leedle, Jr.	Chief Executive Officer and Director (Principal Executive Officer)	March 16, 2010
/s/ Mary A. Chaput Mary A. Chaput	Chief Financial Officer (Principal Financial Officer)	March 16, 2010
/s/ Alfred Lumsdaine Alfred Lumsdaine	Chief Accounting Officer (Principal Accounting Officer)	March 16, 2010
/s/ Thomas G. Cigarran Thomas G. Cigarran	Chairman of the Board and Director	March 16, 2010
/s/ John A. Wickens John A. Wickens	Director	March 16, 2010
/s/ William D. Novelli William D. Novelli	Director	March 16, 2010
/s/ William C. O’Neil, Jr. William C. O'Neil, Jr.	Director	March 16, 2010
/s/ John W. Ballantine John W. Ballantine	Director	March 16, 2010
/s/ Mary Jane England, M.D. Mary Jane England, M.D.	Director	March 16, 2010
/s/ Alison Taunton-Rigby	Director	March 16, 2010

Alison Taunton-Rigby		
/s/ J. Cris Bisgard, M.D. J. Cris Bisgard, M.D.	Director	March 16, 2010
/s/ C. Warren Neel C. Warren Neel	Director	March 16, 2010
/s/ L. Ben Lytle L. Ben Lytle	Director	March 16, 2010