HEALTHWAYS, INC
Form 10-Q
May 09, 2014

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

[x] Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the Quarterly Period Ended March 31, 2014

or

[ ] Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the transition period from _____ to _____

Commission File Number 000-19364
HEALTHWAYS, INC.
(Exact Name of Registrant as Specified in its Charter)

Delaware	62-1117144
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)

701 Cool Springs Boulevard, Franklin, TN 37067
(Address of Principal Executive Offices) (Zip Code)

615-614-4929
(Registrant's Telephone Number, Including Area Code)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes x No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes x No o

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

Large accelerated filer o Accelerated filer x

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No x

As of May 5, 2014, there were outstanding 35,272,245 shares of the registrant's common stock, par value $.001 per share ("common stock").

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Part I

Item 1. Financial Statements

HEALTHWAYS, INC.
CONSOLIDATED BALANCE SHEETS
(In thousands)
(Unaudited)

ASSETS

	March 31, 2014	December 31, 2013
Current assets:		
Cash and cash equivalents	$2,158	$2,584
Accounts receivable, net	113,007	89,484
Prepaid expenses	13,979	9,228
Other current assets	6,527	6,857
Income taxes receivable	3,941	1,402
Deferred tax asset	9,598	9,667
Total current assets	149,210	119,222
Property and equipment:		
Leasehold improvements	37,559	37,463
Computer equipment and related software	296,281	290,392
Furniture and office equipment	23,004	22,881
Capital projects in process	32,880	25,228
	389,724	375,964
Less accumulated depreciation	(228,264)	(217,766)
	161,460	158,198
Other assets	61,011	53,629
Intangible assets, net	76,592	79,162
Goodwill, net	338,800	338,800
Total assets	$787,073	$749,011

See accompanying notes to the consolidated financial statements.

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

LIABILITIES AND STOCKHOLDERS' EQUITY

	March 31, 2014	December 31, 2013
Current liabilities:		
Accounts payable	$40,257	$33,125
Accrued salaries and benefits	14,159	20,157
Accrued liabilities	51,894	32,065
Deferred revenue	6,077	4,496
Contract billings in excess of earned revenue	20,187	17,411
Current portion of long-term debt	16,230	14,340
Current portion of long-term liabilities	1,956	2,822
Total current liabilities	150,760	124,416
Long-term debt	246,692	237,582
Long-term deferred tax liability	29,973	33,320
Other long-term liabilities	64,779	51,003
Stockholders' equity:		
Preferred stock $.001 par value, 5,000,000 shares authorized, none outstanding	—	—
Common stock $.001 par value, 120,000,000 shares authorized, 35,223,754 and 35,107,303 shares outstanding, respectively	35	35
Additional paid-in capital	284,676	283,244
Retained earnings	38,404	48,000
Treasury stock, at cost, 2,254,953 shares in treasury	(28,182)	(28,182)
Accumulated other comprehensive loss	(64)	(407)
Total stockholders' equity	294,869	302,690
Total liabilities and stockholders' equity	$787,073	$749,011

See accompanying notes to the consolidated financial statements.

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

	Three Months Ended March 31,	
	2014	2013
Revenues	$176,777	$165,165
Cost of services (exclusive of depreciation and amortization of $9,372 and $8,825, respectively, included below)	148,148	141,257
Selling, general and administrative expenses	16,431	13,098
Depreciation and amortization	13,336	13,533
Legal settlement charges	9,363	—
Operating loss	(10,501)	(2,723)
Interest expense	4,383	3,321
Loss before income taxes	(14,884)	(6,044)
Income tax benefit	(5,288)	(2,095)
Net loss	$(9,596)	$(3,949)
Loss per share:		
Basic	$(0.27)	$(0.12)
Diluted [1]	$(0.27)	$(0.12)
Comprehensive loss	$(9,253)	$(3,751)
Weighted average common shares and equivalents:		
Basic	35,151	34,018
Diluted [1]	35,151	34,018

(1) The assumed exercise of stock-based compensation awards for the three months ended March 31, 2014 and 2013 was not considered because the impact would be anti-dilutive.

See accompanying notes to the consolidated financial statements.

HEALTHWAYS, INC.
CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY
For the Three Months Ended March 31, 2014
(In thousands)
(Unaudited)

	Preferred Stock	Common Stock	Additional Paid-in Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Loss	Total
Balance, December 31, 2013	$ —	$ 35	$ 283,244	$ 48,000	$ (28,182)	$ (407)	$ 302,690
Comprehensive income (loss)	—	—	—	(9,596)	—	343	(9,253)
Exercise of stock options	—	—	163	—	—	—	163
Tax effect of stock options and restricted stock units	—	—	(430)	—	—	—	(430)
Share-based employee compensation expense	—	—	1,699	—	—	—	1,699
Balance, March 31, 2014	$ —	$ 35	$ 284,676	$ 38,404	$ (28,182)	$ (64)	$ 294,869

See accompanying notes to the consolidated financial statements.

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

	Three Months Ended March 31,	
	2014	2013
Cash flows from operating activities:		
Net loss	$(9,596)	$(3,949)
Adjustments to reconcile net loss to net cash flows provided by operating activities, net of business acquisitions:		
Depreciation and amortization	13,336	13,533
Amortization of deferred loan costs	463	235
Amortization of debt discount	1,630	—
Share-based employee compensation expense	1,699	1,537
Excess tax benefits from share-based payment arrangements	(230)	(137)
(Increase) decrease in accounts receivable, net	(23,190)	15,936
Increase in other current assets	(711)	(128)
Increase in accounts payable	7,436	77
Decrease in accrued salaries and benefits	(6,584)	(7,193)
Increase in other current liabilities	18,387	6,969
Other	6,469	(851)
Net cash flows provided by operating activities	9,109	26,029
Cash flows from investing activities:		
Acquisition of property and equipment	(10,566)	(11,264)
Other	(1,910)	(1,918)
Net cash flows used in investing activities	(12,476)	(13,182)
Cash flows from financing activities:		
Proceeds from issuance of long-term debt	107,225	105,200
Payments of long-term debt	(103,335)	(127,078)
Deferred loan costs	(60)	(744)
Excess tax benefits from share-based payment arrangements	230	137
Exercise of stock options	163	360
Change in outstanding checks and other	(1,589)	10,257
Net cash flows provided by (used in) financing activities	2,634	(11,868)
Effect of exchange rate changes on cash	307	(354)
Net (decrease) increase in cash and cash equivalents	(426)	625
Cash and cash equivalents, beginning of period	2,584	1,759
Cash and cash equivalents, end of period	$2,158	$2,384
Noncash Activities:		
Assets acquired through capital lease obligation	$5,479	$—

See accompanying notes to the consolidated financial statements.

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

(1) Basis of Presentation

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

We have omitted certain financial information that is normally included in financial statements prepared in accordance with U.S. GAAP but that is not required for interim reporting purposes. You should read the accompanying consolidated financial statements in conjunction with the financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2013.

(2) Recent Accounting Standards

In July 2013, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2013-11, "Income Taxes (Topic 740)—Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists," which requires an entity to present in the financial statements an unrecognized tax benefit, or a portion of an unrecognized tax benefit, as a reduction to a deferred tax asset resulting from a net operating loss carryforward, a similar tax loss, or a tax credit carryforward. However, when the above situation is not available at the reporting date or the tax law of the applicable jurisdiction does not require the entity to use the deferred tax asset for such purpose, the unrecognized tax benefit should be presented in the financial statements as a liability and should not be combined with deferred tax assets. ASU No. 2013-11 is effective prospectively for reporting periods beginning after December 15, 2013. We adopted this standard for the interim period beginning January 1, 2014. The adoption of this standard did not have a material impact on our consolidated results of operations, financial position, cash flows, or notes to the consolidated financial statements.

(3) Share-Based Compensation

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

For the three months ended March 31, 2014 and 2013, we recognized share-based compensation costs of $1.7 million and $1.5 million, respectively.

A summary of our stock options as of March 31, 2014 and changes during the three months then ended is presented below:

	Shares (000s)	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (years)	Aggregate Intrinsic Value ($000s)
Options				
Outstanding at January 1, 2014	4,325	$ 15.09		
Granted	15	16.01		
Exercised	(29)	10.81		
Forfeited	(33)	11.57		

Expired	(19	)	31.74		
Outstanding at March 31, 2014	4,259		15.07	6.22	$ 19,083
Exercisable at March 31, 2014	2,447	$	17.84	4.79	$ 8,524

The weighted-average grant-date fair value of options granted during the three months ended March 31, 2014 was $8.80.

The following table shows a summary of our restricted stock and restricted stock units ("nonvested shares") as of March 31, 2014, as well as activity during the three months then ended:

Nonvested Shares	Shares (000s)	Weighted-Average Grant Date Fair Value
Nonvested at January 1, 2014	841	$ 10.44
Granted	—	—
Vested	(122)	10.59
Forfeited	(14)	10.64
Nonvested at March 31, 2014	705	$ 10.42

(4) Income Taxes

Our effective tax benefit rate remained relatively consistent at approximately 36% for the three months ended March 31, 2014 compared to approximately 35% for the three months ended March 31, 2013.

We file income tax returns in the U.S. federal jurisdiction and various state and foreign jurisdictions. Tax years remaining subject to examination in these major jurisdictions include 2010 to present.

(5) Long-Term Debt

1.50% Cash Convertible Senior Notes Due 2018

On July 16, 2013, we issued $150.0 million aggregate principal amount of cash convertible senior notes due 2018 (the "Cash Convertible Notes"), which bear interest at a rate of 1.50% per year, payable semiannually in arrears on January 1 and July 1 of each year, beginning on January 1, 2014. The Cash Convertible Notes will mature on July 1, 2018, unless earlier repurchased or converted into cash in accordance with their terms prior to such date. The Cash Convertible Notes are convertible into cash based on the conversion rate set forth below and are not convertible into our common stock or any other securities under any circumstances. The initial cash conversion rate is 51.38 shares of our common stock per $1,000 principal amount of Cash Convertible Notes (equivalent to an initial conversion price of approximately $19.46 per share of common stock). The Cash Convertible Notes are our senior unsecured obligations and rank senior in right of payment to any of our indebtedness that is expressly subordinated in right of payment to the Cash Convertible Notes. As a result of this transaction, we recognized deferred loan costs of approximately $3.9 million, which are being amortized over the term of the Cash Convertible Notes using the effective interest method.

The cash conversion feature of the Cash Convertible Notes (the "Cash Conversion Derivative") requires bifurcation from the Cash Convertible Notes in accordance with FASB Accounting Standards Codification ("ASC") Topic 815, Derivatives and Hedging, and is recorded in other long-term liabilities as a derivative liability and carried at fair value. The fair value of the Cash Conversion Derivative at the time of issuance of the Cash Convertible Notes was $36.8 million, which was recorded as a debt discount for purposes of accounting for the debt component of the Cash Convertible Notes. The debt discount will be amortized over the term of the Cash Convertible Notes using the effective interest method. For the three months ended March 31, 2014, we recorded $1.6 million of interest expense related to the amortization of the debt discount based upon an effective interest rate of 5.7%.

In connection with the issuance of the Cash Convertible Notes, we entered into privately negotiated convertible note hedge transactions (the "Cash Convertible Notes Hedges"), which are cash-settled and are intended to reduce our exposure to potential cash payments that we would be required to make if holders elect to convert the Cash Convertible Notes at a time when our stock price exceeds the conversion price. The initial cost of the Cash Convertible Notes Hedges was $36.8 million. The Cash Convertible Notes Hedges are recorded in other assets as a derivative asset under FASB ASC Topic 815 and are carried at fair value. See Note 7 for additional information regarding the Cash Convertible Notes Hedges and the Cash Conversion Derivative and their fair values as of March 31, 2014.

In July 2013, we also sold separate privately negotiated warrants (the "Warrants") initially relating, in the aggregate, to a notional number of shares of our common stock underlying the Cash Convertible Notes Hedges. The Warrants have an initial strike price of $25.95 per share, which effectively increases the conversion price of the Notes to a 60% premium to our stock price on July 1, 2013. The Warrants will be net share settled by issuing a number of shares of our common stock per Warrant corresponding to the excess of the market price per share of our common stock (as measured on each warrant exercise date under the terms of the Warrants) over the applicable strike price of the Warrants. The Warrants meet the definition of derivatives under the guidance in ASC Topic 815; however, because these instruments have been determined to be indexed to our own stock and meet the criteria for equity classification under ASC Topic 815-40, the Warrants have been accounted for as an adjustment to our additional paid-in-capital.

If the market value per share of our common stock exceeds the strike price of the Warrants, the Warrants will have a dilutive effect on net income per share, and the "treasury stock" method will be used in calculating the dilutive effect on earnings per share.

CareFirst Convertible Note

On October 1, 2013, we entered into an Investment Agreement (the "Investment Agreement") with CareFirst Holdings, LLC ("CareFirst"), which is in addition to certain existing commercial agreements between us and CareFirst (the "Commercial Agreements"). Pursuant to the Investment Agreement, we issued to CareFirst a convertible subordinated promissory note in the aggregate original principal amount of $20 million (the "CareFirst Convertible Note") for a purchase price of $20 million. The CareFirst Convertible Note bears interest at a rate of 4.75% per year, payable quarterly in arrears on March 31, June 30, September 30 and December 31 of each calendar year, beginning on December 31, 2013. The CareFirst Convertible Note may be prepaid only under limited circumstances and upon the terms and conditions specified therein. If the CareFirst Convertible Note has not been fully converted or redeemed in accordance with its terms, it will mature on October 1, 2019. The CareFirst Convertible Note is subordinate in right of payment to the prior payment in full of (a) all of our indebtedness under the Fifth Amended Credit Agreement (as defined below), and (b) any other of our senior debt, which currently includes only the Cash Convertible Notes.

The CareFirst Convertible Note is convertible into shares of our common stock at the conversion rate determined by dividing (a) the sum of the portion of the principal to be converted and accrued and unpaid interest with respect to such principal by (b) the conversion price equal to $22.41 per share of our common stock. The conversion price is subject to adjustment for stock splits, stock dividends, recapitalizations, reorganizations, reclassifications and similar events.

CareFirst has an opportunity to earn warrants to purchase shares of our common stock ("CareFirst Warrants") based on achievement of certain quarterly thresholds (the "Revenue Thresholds") for revenue derived from both the Commercial Agreements and from new business to us from third parties as a result of an introduction or referral to us by CareFirst (collectively, the "Quarterly Revenue"). If the Quarterly Revenue is greater than or equal to the applicable Revenue Threshold for any quarter ending on or prior to September 30, 2017, then we will issue to CareFirst a certain number of warrants exercisable for the number of shares of our common stock ("CareFirst Warrant Shares") determined in accordance with the terms of the Investment Agreement unless (i) CareFirst elects to receive a cash payment in accordance with the terms of the Investment Agreement or (ii) there is a change of control. The aggregate number of CareFirst Warrant Shares in any single 12-month period beginning on October 1, 2013 cannot exceed 400,000, and the aggregate number of CareFirst Warrant Shares issuable pursuant to the Investment Agreement cannot exceed 1,600,000. If issued, the CareFirst Warrants will have a dilutive effect on net income per share, and the "treasury stock" method will be used in calculating the dilutive effect on earnings per share.

Also on October 1, 2013, in connection with the execution of the Investment Agreement, we entered into a Registration Rights Agreement with CareFirst, pursuant to which we agreed to use commercially reasonable efforts to cause any registration statement covering an underwritten offering of our common stock for our own account or for the account of any holder of our common stock (other than a registration statement on Form S-4 or Form S-8 or any successor thereto) to include those registrable common shares that any holder of such registrable common shares has requested to be registered.

The term of the Investment Agreement expires on the earlier of (a) December 31, 2017 and (b) the first date on which no Commercial Agreement is in effect.

Credit Facility

On June 8, 2012, we entered into the Fifth Amended and Restated Revolving Credit and Term Loan Agreement (as amended, the "Fifth Amended Credit Agreement"). The Fifth Amended Credit Agreement provides us with a $200.0 million revolving credit facility that expires on June 8, 2017 and includes a swingline sub facility of $20.0 million and a $75.0 million sub facility for letters of credit. The Fifth Amended Credit Agreement also provides a $200.0 million term loan facility that matures on June 8, 2017, $107.5 million of which remained outstanding at March 31, 2014, and an uncommitted incremental accordion facility of $200.0 million.

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

On February 5, 2013, we entered into an amendment to the Fifth Amended Credit Agreement, which included, among other things, a temporary increase in the LIBOR and Base Rate margins of 0.25%. The increased margins were effective through December 31, 2013 and apply only in the event that our total funded debt to EBITDA ratio is greater than or equal to 3.50 to 1.00. On July 1, 2013, we entered into an additional amendment to the Fifth Amended Credit Agreement, which provided for, among other things, the amendment of certain negative covenants to permit the issuance of and payments related to the cash convertible notes described above as well as increases in the maximum required levels of total funded debt to EBITDA beginning with the quarter ended June 30, 2013.

On April 15, 2014, in connection with the agreement to resolve the contract dispute with Blue Cross Blue Shield of Minnesota ("BCBSMN") as discussed in Note 8, we entered into an additional amendment to the Fifth Amended Credit Agreement that provided for an add-back to our consolidated EBITDA, which is used for purposes of calculating financial covenants under the Fifth Amended Credit Agreement, for the $9.4 million charge incurred as a result of the settlement of the dispute with BCBSMN. As of March 31, 2014, availability under the revolving credit facility totaled $35.1 million as calculated under the most restrictive covenant.

We are required to repay outstanding revolving loans under the revolving credit facility in full on June 8, 2017. We are required to repay term loans in quarterly principal installments aggregating (1) 1.250% of the original aggregate principal amount of the term loans during each of the eight quarters beginning with the quarter ended September 30, 2012, (2) 1.875% of the original aggregate principal amount of the term loans during each of the next four quarters beginning with the quarter ending September 30, 2014, and (3) 2.500% of the original aggregate principal amount of the term loans during each of the remaining quarters prior to maturity on June 8, 2017, at which time the entire unpaid principal balance of the term loans is due and payable.

The Fifth Amended Credit Agreement contains financial covenants that require us to maintain, as defined, specified ratios or levels of (1) total funded debt to EBITDA and (2) fixed charge coverage. As of March 31, 2014, we were in compliance with all of the financial covenant requirements of the Fifth Amended Credit Agreement.

The Fifth Amended Credit Agreement contains various other affirmative and negative covenants that are typical for financings of this type. Among other things, the Fifth Amended Credit Agreement limits repurchases of our common stock and the amount of dividends that we can pay to holders of our common stock.

(6) Derivative Investments and Hedging Activities

We use derivative instruments to manage risks related to interest rate swap agreements, foreign currencies, and the Cash Convertible Notes. We account for derivatives in accordance with FASB ASC Topic 815, which establishes accounting and reporting standards requiring that certain derivative instruments be recorded on the balance sheet as either an asset or liability measured at fair value. Additionally, changes in the derivative's fair value will be recognized currently in earnings unless specific hedge accounting criteria are met. As permitted under our master netting arrangements, the fair value amounts of our interest rate swaps and foreign currency options and/ or forward contracts are presented on a net basis by counterparty in the consolidated balance sheets.

Derivative Instruments Designated as Hedging Instruments

Cash Flow Hedges

Derivative instruments that are designated and qualify as cash flow hedges are recorded at estimated fair value in the consolidated balance sheets, with the effective portion of the gains and losses being reported in accumulated other comprehensive income or loss ("accumulated OCI"). Cash flow hedges for all periods presented consist solely of interest rate swap agreements, which effectively modify our exposure to interest rate risk by converting a portion of our floating rate debt to fixed rate obligations, thus reducing the impact of interest rate changes on future interest expense. Under these agreements, we receive a variable rate of interest based on LIBOR (as defined in Note 5), and we pay a fixed rate of interest with interest rates ranging from 0.690% to 1.480% plus a spread (see Note 5). We maintain interest rate swap agreements with current notional amounts of $145.0 million and termination dates ranging from November 2015 to December 2016. Of this amount, $95.0 million was effective at March 31, 2014, and $50.0 million will become effective in December 2015, as older interest rate swap agreements expire. Gains and losses on these interest rate swap agreements are reclassified to interest expense in the same period during which the hedged transaction affects earnings or the period in which all or a portion of the hedge becomes ineffective. As of March 31, 2014, we expect to reclassify $0.4 million of net losses on interest rate swap agreements from accumulated OCI to interest expense within the next 12 months due to the scheduled payment of interest associated with our debt.

The following table shows the effect of our cash flow hedges on the consolidated balance sheets during the three months ended March 31, 2014 and 2013:

(In $000s)	For the Three Months Ended	
Derivatives in Cash Flow Hedging Relationships	March 31, 2014	March 31, 2013
Loss related to effective portion of derivatives recognized in accumulated OCI, gross of tax effect	$66	$58
Loss related to effective portion of derivatives reclassified from accumulated OCI to interest expense, gross of tax effect	$126	$629

Gains and losses representing either hedge ineffectiveness or hedge components excluded from the assessment of effectiveness are recognized in current earnings. During the three months ended March 31, 2014 and 2013, there were no gains or losses on cash flow hedges recognized in our consolidated statements of comprehensive income (loss) resulting from hedge ineffectiveness.

Derivative Instruments Not Designated as Hedging Instruments

Our Cash Conversion Derivative, Cash Convertible Notes Hedges, and foreign currency options and/or forward contracts do not qualify for hedge accounting treatment under U.S. GAAP and are measured at fair value with gains and losses recognized immediately in the consolidated statements of comprehensive income (loss). These derivative instruments not designated as hedging instruments did not have a material impact on our consolidated statements of comprehensive income (loss) during the three months ended March 31, 2014 or 2013.

Cash Conversion Derivative and Cash Convertible Notes Hedges

The Cash Conversion Derivative is accounted for as a derivative liability and carried at fair value. In order to offset the risk associated with the Cash Conversion Derivative, we entered into Cash Convertible Notes Hedges which are cash-settled and are intended to reduce our exposure to potential cash payments that we would be required to make if holders elect to convert the Cash Convertible Notes at a time when our stock price exceeds the conversion price. The Cash Convertible Notes Hedges are accounted for as a derivative asset and carried at fair value.

The gains and losses resulting from a change in fair values of the Cash Conversion Derivative and the Cash Convertible Notes Hedges are reported in the consolidated statements of comprehensive loss as follows:

(In $000s)	Three Months Ended March 31, 2014	Statements of Comprehensive Loss Classification
Cash Convertible Notes Hedges:		
Net unrealized gain	$7,731	Selling, general and administrative expenses
Cash Conversion Derivative:		
Net unrealized loss	$(7,731)	Selling, general and administrative expenses

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Foreign Currency Exchange Contracts

We also 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 require current period mark-to-market accounting, with any change in fair value being recorded each period in the consolidated statements of comprehensive income (loss) in selling, general and administrative expenses. At March 31, 2014, we had forward contracts with notional amounts of $21.1 million to exchange foreign currencies, primarily the Australian dollar and Euro, that were entered into to hedge forecasted foreign net income (loss) and intercompany debt. 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 March 31, 2014 and December 31, 2013, excluding the impact of netting derivative assets and liabilities when a legally enforceable master netting agreement exists, were as follows:

	March 31, 2014			December 31, 2013		
(In $000s)	Foreign currency exchange contracts	Interest rate swap agreements	Cash Convertible Notes Hedges and Cash Conversion Derivative	Foreign currency exchange contracts	Interest rate swap agreements	Cash Convertible Notes Hedges and Cash Conversion Derivative
Assets:						
Derivatives not designated as hedging instruments:						
Other current assets	$52	$ —	$ —	$178	$ —	$ —
Other assets	—	—	35,497	—	—	27,766
Total assets	$52	$ —	$ 35,497	$178	$ —	$ 27,766
Liabilities:						
Derivatives not designated as hedging instruments:						
Accrued liabilities	$159	$ —	$ —	$67	$ —	$ —
Other long-term liabilities	—	—	35,497	—	—	27,766
Derivatives designated as hedging instruments:						
Accrued liabilities	—	—	—	—	—	—
Other long-term liabilities	—	471	—	—	505	—
Total liabilities	$159	$ 471	$ 35,497	$67	$ 505	$ 27,766

See also Note 7.

(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 tables present our assets and liabilities measured at fair value on a recurring basis at March 31, 2014 and December 31, 2013:

(In $000s) March 31, 2014	Level 2	Level 3	Gross Fair Value	Netting[(1)]	Net Fair Value
Assets:					
Foreign currency exchange contracts	$52	$—	$52	$ (27)	$25
Cash Convertible Notes Hedges	—	35,497	35,497	—	35,497
Liabilities:					
Foreign currency exchange contracts	$159	$—	$159	$ (27)	$132
Interest rate swap agreements	471	—	471	—	471
Cash Conversion Derivative	—	35,497	35,497	—	35,497

(In $000s) December 31, 2013	Level 2	Level 3	Gross Fair Value	Netting[(1)]	Net Fair Value
Assets:					
Foreign currency exchange contracts	$178	$—	$178	$ (57)	$121
Cash Convertible Notes Hedges	—	27,766	27,766	—	27,766
Liabilities:					
Foreign currency exchange contracts	$67	$—	$67	$ (57)	$10
Interest rate swap agreements	505	—	505	—	505
Cash Conversion Derivative	—	27,766	27,766	—	27,766

(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 fair values of the Cash Convertible Notes Hedges and the Cash Conversion Derivative are measured using Level 3 inputs. These instruments are not actively traded and are valued using an option pricing model that uses observable and unobservable market data for inputs, such as expected time to maturity of the derivative instruments, the risk-free interest rate, the expected volatility of our common stock and other factors. The Cash Convertible Notes Hedges and the Cash Conversion Derivative were designed such that changes in their fair values would offset one another, with minimal impact to the consolidated statements of comprehensive income (loss). Therefore, the sensitivity of changes in the unobservable inputs to the option pricing model for such instruments is mitigated.

The following table presents our financial instruments measured at fair value on a recurring basis using unobservable inputs (Level 3):

(In $000s)	Balance at December 31, 2013	Purchases of Level 3 Instruments	Issuances of Level 3 Instruments	Gains/(Losses) Included in Earnings	Balance at March 31, 2014

Cash Convertible Notes Hedges	$27,766	$ —	$ —	$ 7,731	$35,497
Cash Conversion Derivative	(27,766)	—	—	(7,731)	(35,497)

The gains and losses included in earnings noted above represent the change in the fair value of these financial instruments and are recorded each period in the consolidated statements of comprehensive income (loss) as selling, general and administrative expenses.

Fair Value of Other Financial Instruments

In addition to foreign currency exchange contracts, interest rate swap agreements, the Cash Convertible Notes Hedges, and the Cash Conversion Derivative, the estimated fair values of which are disclosed above, the estimated fair value of each class of financial instruments at March 31, 2014 was as follows:

- Cash and cash equivalents – The carrying amount of $2.2 million approximates fair value because of the short maturity of those instruments (less than three months).

- Long-term debt – The estimated fair value of outstanding borrowings under the Fifth Amended Credit Agreement, which includes a revolving credit facility and a term loan facility (see Note 5), and the Cash Convertible Notes are determined based on the fair value hierarchy as discussed above. The revolving credit facility and the term loan facility are not actively traded and therefore are classified as Level 2 valuations based on the market for similar instruments. The estimated fair value is based on the average of the prices set by the issuing bank given current market conditions and is not necessarily indicative of the amount we could realize in a current market exchange. The estimated fair value and carrying amount of outstanding borrowings under the Fifth Amended Credit Agreement at March 31, 2014 are $117.7 million and $118.3 million, respectively.

The Cash Convertible Notes are actively traded and therefore are classified as Level 1 valuations. The estimated fair value at March 31, 2014 was $157.4 million, which is based on the last traded price of the Cash Convertible Notes on March 31, 2014, and the par value was $150.0 million. The carrying amount of the Cash Convertible Notes at March 31, 2014 was $118.0 million, which is net of the debt discount discussed in Note 5.

The CareFirst Convertible Note was issued at its fair value of $20.0 million on October 1, 2013. It is not actively traded and is not based upon either an observable market, other than the market for our common stock, or on an observable index and is therefore classified as a Level 3 valuation. At March 31, 2014, the carrying amount of the CareFirst Convertible Note of $20.0 million approximates fair value because there were no factors present that would result in a change in the fair value since its issuance on October 1, 2013.

(8) Commitments and Contingencies

Contract Disputes

On January 25, 2010, Blue Cross Blue Shield of Minnesota issued notice of arbitration with the American Arbitration Association in Minneapolis in accordance with the terms of the contract alleging violations of certain contract provisions and seeking recoupment of an unspecified amount of payments made to us under the contract. We believe we performed our services in compliance with the terms of our agreement and that the assertions made in the arbitration notice are without merit. On August 3, 2011, we asserted numerous counterclaims against BCBSMN. On April 15, 2014, we entered into an agreement with BCBSMN to resolve this dispute. Under the terms of the agreement, we agreed to pay BCBSMN in two separate installments: $4 million by the end of April 2014 and $5.5 million in January 2015. BCBSMN has an option to receive discounts on our well-being improvement services in lieu of the January 2015 payment.

We are involved in a contractual dispute with Plastipak Packaging, Inc. ("Plastipak"). On September 10, 2012, Plastipak filed suit in the Circuit Court for Wayne County, Michigan seeking damages relating to an alleged breach of a services agreement with us. The case is currently in the discovery phase of litigation. We deny Plastipak's claims and intend to vigorously defend the action.

Performance Award Lawsuit

On September 4, 2012, Milton Pfeiffer ("Plaintiff"), claiming to be a stockholder of the Company, filed a putative derivative action against the Company and the Board of Directors (the "Board") in Delaware Chancery Court (the "Court") alleging that the Compensation Committee of the Board and the Board breached their fiduciary duties and violated the Company's 2007 Stock Incentive Plan (the "Plan") by granting Ben R. Leedle, Jr., Chief Executive Officer and President of the Company, discretionary performance awards under the Plan in the form of options to purchase an aggregate of 500,000 shares of the Company's common stock, which consisted of a performance award in

November 2011 granting Mr. Leedle the right to purchase 365,000 shares and a performance award in February 2012 granting Mr. Leedle the right to purchase 135,000 shares (the "Performance Awards"). Plaintiff alleges that the Performance Awards exceeded what is authorized by the Plan and that the Company's 2012 proxy statement, in which the Performance Awards are disclosed, is false and misleading. Plaintiff also alleges that Mr. Leedle breached his fiduciary duties and was unjustly enriched by receiving the Performance Awards. Plaintiff is seeking, among other things, the rescission or disgorgement of all alleged "excess" awards granted to Mr. Leedle under the Performance Awards, to recover any incidental damages to the Company, and an award of attorneys' fees and expenses. On November 2, 2012, the Company and the Board filed a Motion to Dismiss because Plaintiff failed to make a demand upon the Board as required by Delaware law. On November 8, 2013, the Court denied the Company's Motion to Dismiss. On February 21, 2014, the Company filed its answer and intends to vigorously defend the allegations.

Outlook

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

Contractual Commitments

We entered into a 25-year strategic relationship agreement with Gallup in January 2008 and a global joint venture agreement with Gallup in October 2012 that requires us to make payments over a 5-year period beginning January 2013. We have minimum remaining contractual cash obligations of $40.1 million related to these agreements.

In May 2011, we entered into a ten-year applications and technology services outsourcing agreement with HP Enterprise Services, LLC that contains minimum fee requirements. Total payments over the remaining term, including an estimate for future contractual cost of living adjustments, must equal or exceed a minimum level of approximately $136.2 million; however, based on initial required service and equipment level assumptions, we estimate that the remaining payments will be approximately $283.3 million. The agreement allows us to terminate all or a portion of the services after the first two years provided we pay certain termination fees, which could be material to the Company.

(9) Earnings Per Share

The following is a reconciliation of the numerator and denominator of basic and diluted earnings per share for the three months ended March 31, 2014 and 2013:

(In 000s, except per share data)	Three Months Ended	
	March 31, 2014	March 31, 2013
Numerator:		
Net loss - numerator for basic loss per share	$(9,596)	$(3,949)
Denominator:		
Shares used for basic loss per share	35,151	34,018
Effect of dilutive securities outstanding:		
Non-qualified stock options	—	—
Restricted stock units	—	—
Shares used for diluted loss per share	$35,151	$34,018
Loss per share:		
Basic	$(0.27)	$(0.12)
Diluted (1)	$(0.27)	$(0.12)
Dilutive securities outstanding not included in the computation of loss per share because their effect is antidilutive:		
Non-qualified stock options	2,571	4,276
Restricted stock units	332	489

Warrants related to Cash Convertible Notes	7,707	—
CareFirst Convertible Note	892	—

[(1)] The assumed exercise of stock-based compensation awards for the three months ended March 31, 2014 and 2013 was not considered because the impact would be anti-dilutive.

(10) Accumulated OCI

The following tables summarize the changes in accumulated OCI, net of tax, for the three months ended March 31, 2014 and 2013:

(In $000s)	Net Change in Fair Value of Interest Rate Swaps	Foreign Currency Translation Adjustments	Total
Accumulated OCI, net of tax, as of January 1, 2014	$ (513)	$ 106	$ (407)
Other comprehensive income (loss) before reclassifications, net of tax	(30)	297	267
Amounts reclassified from accumulated OCI, net of tax	76	—	76
Net increase in other comprehensive income (loss), net of tax	46	297	343
Accumulated OCI, net of tax, as of March 31, 2014	$ (467)	$ 403	$ (64)

(In $000s)	Net Change in Fair Value of Interest Rate Swaps	Foreign Currency Translation Adjustments	Total
Accumulated OCI, net of tax, as of January 1, 2013	$ (1,790)	$ 861	$ (929)
Other comprehensive loss before reclassifications, net of tax	(35)	(147)	(182)
Amounts reclassified from accumulated OCI, net of tax	380	—	380
Net increase (decrease) in other comprehensive income (loss), net of tax	345	(147)	198
Accumulated OCI, net of tax, as of March 31, 2013	$ (1,445)	$ 714	$ (731)

The following table provides details about reclassifications out of accumulated OCI for the three months ended March 31, 2014 and 2013:

(In $000s)	Three Months Ended March 31, 2014	2013	Statement of Comprehensive Loss Classification
Interest rate swaps	$ 126	$ 629	Interest expense
	(50)	(249)	Income tax benefit
	$ 76	$ 380	Net of tax

See Note 6 for further discussion of our interest rate swaps.

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

Overview

Founded and incorporated in Delaware in 1981, Healthways, Inc., together with its wholly-owned subsidiaries, provides specialized, comprehensive solutions to help people improve their well-being, thereby improving their health and productivity and reducing their health-related costs.

We believe well-being consists of five essential elements:

· Physical: Having good health and enough energy to get things done daily

· Financial: Managing your economic life to reduce stress and increase security

· Social: Having supportive relationships and love in your life

· Community: Liking where you live, feeling safe and having pride in your community

· Purpose: Liking what you do each day and being motivated to achieve your goals

Our solutions provide highly specific and personalized interventions for each individual in a population, irrespective of health status, age or paying sponsor. Our solutions are designed to change behaviors across an entire population over time to keep healthy people healthy, eliminate or reduce lifestyle risks and optimize care for persistent or chronic conditions. Through a simple, but powerful, data-driven process we identify the needs of each individual and determine the right level of support. This allows us to deploy successful strategies efficiently to sustain engagement, to use the best science to drive behavior change and ultimately deliver meaningful, measurable outcomes. Our services are delivered using a range of methods including venue-based face-to-face interactions; print; phone; mobile and remote devices with unique applications; on-line including social networks; and any combination thereof to motivate and sustain healthy behaviors.

In North America, our customers include health plans, both commercial and Medicare Advantage, large self-insured employers, including state and municipal government entities, and providers of healthcare, including integrated healthcare systems, hospitals, and physician groups, in all 50 states and the District of Columbia. We also provide services to commercial healthcare businesses and/or government entities in Brazil, Australia, and France. All of our interventions were developed with over 30 years of experience based in science and ongoing innovation. Our technology-driven infrastructure is compatible with, and integrated into, our customer and other vendor systems. We operate domestic and international well-being improvement call centers staffed with a wide range of licensed health professionals. Our fitness center network encompasses approximately 15,000 U.S. locations. We also maintain an extensive network of over 88,000 complementary, alternative and physical medicine practitioners, which offers convenient access to the significant number of individuals who seek health services outside of the traditional healthcare system.

Our guiding philosophy and approach to market are predicated on the fundamental belief that healthier people cost less and are more productive. As part of our population health platform, our proprietary analytics and predictive models enable us to stratify the population, develop individualized well-being plans and actions, and deliver solutions to improve individual and organizational well-being.

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

· fostering wellness and disease prevention through total population screening, well-being assessments and supportive interventions; and

- engaging people in our well-being improvement programs and networks, such as fitness, weight management, stress management, financial and lifestyle management skills, chiropractic, and complementary and alternative medicine.

Our prevention programs focus on education, physical fitness, nutrition, health coaching, and tools that support behavior change. These programs improve the well-being status of member populations and reduce the short- and long-term health-related costs for participants, including associated costs from the loss of employee productivity. Many of our programs for lifestyle support, management and education are delivered through web-based portals and mobile applications and may also offer a social networking enhancement opportunity. Our web-based tools and our educational capabilities include the Well-Being Connect® portal and the Dave Ramsey Core™ Financial Wellness program. We also utilize mobile applications such as wellbeingGO®, and our MeYou Health subsidiary unique mobile applications include Well-Being Tracker™, Daily Challenge®, and Walkadoo™.

Second, our programs are designed to eliminate or reduce lifestyle risks by:

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

We engage our customers' covered populations through specific interactions that are sensitive to each individual's health risks and needs. In many situations, we utilize predictive modeling capabilities to allow us to identify and stratify those participants who are most at risk for an adverse health event. Our programs are designed to motivate people to make positive lifestyle changes and accomplish individual goals, such as increasing physical activity for seniors through the Healthways SilverSneakers® fitness solution, overcoming nicotine addiction through the QuitNet® on-line smoking cessation community, or generating sustainable weight-loss through our Innergy® solution.

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

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

Our approach is to use proprietary, analytic models to identify individuals who are likely to incur future high costs, including those who have specific gaps in care, and through evidence-based interventions drive adherence to proven standards of care, medication regimens and physicians' plans of care to reduce disease progression and related medical spending. Specific examples of interventions include our Care Transitions hospital readmissions avoidance program and the Dr. Dean Ornish Program for Reversing Heart Disease™.

We recognize that each individual in a given population plays a variety of roles in his or her pursuit of improved well-being, 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 that real and sustainable behavior change generates measurable, long-term cost savings and improved individual and business performance for our customers.

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Forward-Looking Statements

Management's Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements, which are based upon current knowledge, assumptions, beliefs, estimates and expectations, involve a number of risks and uncertainties, and are subject to the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements include all statements that are not historical statements of fact and those regarding the intent, belief, or expectations of the Company, including, without limitation, all statements regarding the Company's future earnings and results of operations, and can be identified by the use of words like "may," "believe," "will," "expect," "project," "estimate," "anticipate," "plan," or "continue" and similar expressions. Readers are cautioned that any such forward-looking statements are not guarantees of future performance and involve significant risks and uncertainties, and that actual results may vary from those in the forward-looking statements as a result of various factors, including, but not limited to:

- the effectiveness of management's strategies and decisions;
- our ability to sign and implement new contracts for our solutions;
- our ability to accurately forecast the costs required to successfully implement new contracts;
- our ability to renew and/or maintain contracts with our customers under existing terms or restructure these contracts on terms that would not have a material negative impact on our results of operations;
- our ability to effectively compete against other entities, whose financial, research, staff, and marketing resources may exceed our resources;
- our ability to accurately forecast our revenues, margins, earnings and net income, as well as any potential charges that we may incur as a result of changes in our business;
- our ability to accurately forecast performance and the timing of revenue recognition under the terms of our customer contracts ahead of data collection and reconciliation;
- the costs and management distraction related to a proxy contest;
- the impact of the Patient Protection and Affordable Care Act, as amended by the Health Care and Education Reconciliation Act of 2010 (collectively, "PPACA") on our operations and/or the demand for our services;
- our ability to anticipate change and respond to emerging trends in the domestic and international markets for healthcare and the impact of the same on demand for our services;
- the risks associated with deriving a significant concentration of our revenues from a limited number of customers;
- the risks associated with foreign currency exchange rate fluctuations and our ability to hedge against such fluctuations;
- our ability to achieve and reach mutual agreement with customers with respect to the contractually required performance metrics, cost savings and clinical outcomes improvements, or to achieve such metrics, savings and improvements within the timeframes contemplated by us;

- our ability to achieve estimated annualized revenue in backlog in the manner and within the timeframe we expect, which is based on certain estimates regarding the implementation of our services;
- our ability and/or the ability of our customers to enroll participants and to accurately forecast their level of enrollment and participation in our programs in a manner and within the timeframe anticipated by us;
- the ability of our customers to provide timely and accurate data that is essential to the operation and measurement of our performance under the terms of our contracts;
- our ability to favorably resolve contract billing and interpretation issues with our customers;
- our ability to service our debt (including the Cash Convertible Notes and CareFirst Convertible Note), make principal and interest payments as those payments become due, and remain in compliance with our debt covenants;
- the risks associated with changes in macroeconomic conditions, which may reduce the demand and/or the timing of purchases for our services from customers or potential customers, reduce the number of covered lives of our existing customers, or restrict our ability to obtain additional financing;
- counterparty risk associated with the Cash Convertible Notes Hedges, interest rate swap agreements, and foreign currency exchange contracts;
- the risks associated with valuation of the Cash Convertible Notes Hedges and the Cash Conversion Derivative, which may result in volatility to our consolidated statements of comprehensive income (loss) if these transactions do not completely offset one another;
- our ability to integrate new or acquired businesses, services (including outsourced services), or

technologies into our business and to accurately forecast the related costs;

- our ability to anticipate and respond to strategic changes, opportunities, and emerging trends in our industry and/or business and to accurately forecast the related impact on our revenues and earnings;

- the impact of any impairment of our goodwill or other intangible assets;

- our ability to develop new products and deliver and report outcomes on those products;

- our ability to implement our integrated data and technology solutions platform within the required timeframe and expected cost estimates and to develop and enhance this platform and/or other technologies to meet evolving customer and market needs;

- our ability to obtain adequate financing to provide the capital that may be necessary to support our operations and to support or guarantee our performance under new contracts;

- unusual and unforeseen patterns of healthcare utilization by individuals with diseases or conditions for which we provide services;

- the ability of our customers to maintain the number of covered lives enrolled in the plans during the terms of our agreements;

- the risks associated with data privacy or security breaches, computer hacking, network penetration and other illegal intrusions;

- the impact of any new or proposed legislation, regulations and interpretations relating to the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 and any legislative or regulatory changes with respect to Medicare Advantage;

- the impact of future state, federal, and international legislation and regulations applicable to our business, including PPACA, on our ability to deliver our services and on the financial health of our customers and their willingness to purchase our services;

- current geopolitical turmoil, the continuing threat of domestic or international terrorism, and the potential emergence of a health pandemic;
- the impact of legal proceedings involving us and/or our subsidiaries; and
- other risks detailed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2013 and in this Report, including those set forth in Part II, Item IA. "Risk Factors."

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

Customer Contracts

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

Our contracts with health plans and integrated healthcare systems generally range from three to five years with several comprehensive strategic agreements extending up to ten years in length. Contracts with self-insured employers typically have two to four-year terms. Some of our contracts allow the customer to terminate early.

Some of our contracts place a portion of our fees at risk based on achieving certain performance metrics, cost savings, and/or clinical outcomes improvements ("performance-based"). Approximately 2% of revenues recorded during the three months ended March 31, 2014 were performance-based and 1% were subject to final reconciliation as of March 31, 2014.

Technology

Our solutions require sophisticated analytical, data management, Internet, and computer-telephony capabilities based on state-of-the-art technology. These solutions help us deliver our services to large populations within our customer base at scale. Our predictive modeling capabilities, including insights gained from well-being assessments such as the Gallup-Healthways Well-Being 5™ diagnostic tool, allow us to identify and stratify those participants who are most at risk for an adverse health event. We incorporate behavior-change science with consumer-friendly interactions to facilitate consumer preferences for engagement and convenience supporting improvement across all five elements of well-being: physical, financial, social, purpose and community. We use sophisticated data analytical and reporting solutions to validate the impact of our programs on clinical and financial outcomes. Our application offerings support integrating the primary care physician into the team of well-being experts working on behalf of participants.

We have completed a strategic transformation from a business that solely provided disease management services to a business that now provides a much broader array of population health and well-being services - a process that has been underway for approximately seven years. While our transformation-related infrastructure and technology investments are complete, we continue to invest in technology, as evidenced by our long-term applications and technology services outsourcing agreement with HP Enterprise Services, LLC, and are continually refining our proprietary clinical, data management, and reporting systems to continue to meet the information management requirements of our services. The behavior change techniques and predictive modeling incorporated in our technology identify an individual's readiness to change and provide personalized support through appropriate interactions using a range of methods desired by an individual, including venue-based face-to-face; print; phone; mobile and remote devices; on-line; and any combination thereof to motivate and sustain healthy behaviors.

Business Strategy

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

Our business strategy reflects our passion to enhance well-being, resulting in reduced overall health-related costs, improved workforce engagement and improved productivity which yields better performance for individuals, families, health plans, governments, employers, integrated healthcare systems, and communities. Our solutions are designed to improve well-being by helping to:

- keep healthy people healthy;
- eliminate or reduce lifestyle risks; and
- optimize care for persistent or chronic conditions.

We believe it is critical to impact an entire population's well-being and underlying health status in a long-term, cost-effective way. Believing that what gets measured gets acted upon, in 2008, we entered into an exclusive, 25-year relationship with Gallup to create a definitive measure and empiric database of changes in the well-being of the U.S. population, known as the Gallup-Healthways Well-Being Index® ("WBI"), as well as processes to establish benchmarking for purposes of comparing the well-being of any subset of the national population. The responses to the over 1.9 million completed WBI surveys to date have provided Gallup and us with an unmatched database to support our mutual goal of understanding the causes and effects of well-being for a population. In October 2012, we created a global joint venture with Gallup that has developed the next generation of Gallup-Healthways individual well-being assessment tools, the Gallup-Healthways Well-Being 5, to provide employers, health providers, insurers and other interested parties with a validated capability to assess, measure and report on changes in the well-being of their employees, patients, members and customers.

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

We have completed a strategic transformation from a business that solely provided disease management services to a business that now provides a much broader array of population health and well-being services—a process that has been underway for approximately seven years. Our strategy includes, the ongoing refinement of our value proposition through our total population management capabilities. We continue to enhance our well-being improvement solutions to extend our reach and effectiveness and to meet increasing demand for individualized, integrated solutions. The flexibility of our programs allows customers to provide a range of services they deem appropriate for their organizations. Customers may select from certain single program options up to a total-population approach, in which all members of a customer's population are eligible to receive our services. Our strategy also includes the ongoing enhancement and deployment of our proprietary technology platform known as Embrace®. This platform, which is essential to our total population management solution, enables us to integrate data from the healthcare organizations and other entities interacting with an individual. Embrace provides for the delivery of our integrated solutions and ongoing communications between the individual and his or her medical and health experts, using a range of methods, including venue-based face-to-face interactions; print; phone; mobile and remote devices with unique applications; on-line including social networks; and any combination thereof to motivate and sustain healthy behaviors.
A number of contracts signed since 2011 have expanded both the level of integration and breadth of services provided to major regional commercial health plans, in some cases as they develop and implement a number of patient-centered medical home models. Our services extend beyond chronic care and wellness programs to include a full range of care management functions, as well as a variety of health promotion, prevention and quality improvement solutions. Examples include our collaboration with Blue Zones, LLC in delivering a scaled well-being improvement solution to support health plan initiatives in a number of states; our wholly-owned subsidiary MeYou Health, LLC in bringing to market well-being improvement tools in the social media space through Internet and personal device delivery methods; and our exclusive partnership with Dr. Ornish that is creating access to the Dr. Dean Ornish Program for Reversing Heart Disease for a growing number of health plans.

We continue to provide a variety of services to most of the major Medicare Advantage health plans. We expect this market to grow due to the continuing trend of enrollment growth in Medicare Advantage as the size of the Medicare-eligible population increases. Our Silver Sneakers program is the largest single program within our current services. In addition, some of our Medicare Advantage health plan customers are adding additional services including web-based and mobile applications for personal support and social networking as more of the senior population becomes interested in these modalities of interaction.

Self-insured employers, including state and municipal government entities acting as employers, continue to demand services that focus across the entire population of employees and their dependent family members. Our well-being improvement solution, in addition to improving individuals' health and reducing direct healthcare costs, targets a much larger improvement in employer performance and profitability by reducing the impact of productivity lost for health-related reasons. With the success of our work aimed at total population management, we expect to gain an even greater competitive advantage in responding to employers' needs for a healthier, higher-performing, and less costly workforce.

Significant ongoing changes in government regulation of healthcare continue to afford us expanding opportunities to provide services to integrated healthcare systems, hospitals, and physicians, in addition to health plans and employers. In 2011, we acquired Navvis & Company, a well-established provider of strategic counsel and change management services enabling its healthcare system clients to become future-ready clinical enterprises within healthcare's rapidly emerging value-based reimbursement system. Our strategy includes providing integrated healthcare systems, hospitals, and physician enterprises with both consultative strategic planning services and a range of capabilities that enable and support the delivery of Physician-Directed Population Health solutions. We expect to continue to grow the number and size of our health systems relationships through the ongoing deployment of services including, for example, consulting, hospital readmission avoidance and the Dr. Dean Ornish Program for Reversing Heart Disease, in addition to the aggregation of risk lives within health systems for our total population management services.

We expect to continue to expand our international business in countries currently served - Australia, Brazil, and France - and to develop business in additional countries. Our strategy is to help countries with single-payor models that to a large extent have a relatively fixed infrastructure that can be leveraged through our effective care coordination models. This approach allows us to partner either directly with government entities or with the private side of healthcare insurers and service providers that operate in those countries. Though most international business development has a relatively long sales cycle, the pipeline of opportunities continues to grow.

We have completed a strategic transformation from a business that solely provided disease management services to a business that now provides a much broader array of population health and well-being services, a process that has been underway for approximately seven years. We plan to increase our competitive advantage in delivering our services by leveraging the scope of our well-being improvement capabilities, including our medical information content, behavior change processes and techniques, strategic relationships, health provider networks, and fitness center relationships. We also plan to continue to scale the delivery of our solutions employing a blend of our scalable, state-of-the-art well-being improvement call centers and proprietary technologies, modalities, and techniques. While our core population health infrastructure and technology investments are complete and our highly scalable platform is in place, we may add new capabilities and technologies through internal development, strategic alliances with other entities, and/or selective acquisitions or investments.

Critical Accounting Policies

We describe our accounting policies in Note 1 of the Notes to the Consolidated Financial Statements in our Annual Report on Form 10-K for the fiscal year ended December 31, 2013. 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

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

Our contracts with health plans and integrated healthcare systems generally range from three to five years with a number of comprehensive strategic agreements extending up to ten years in length. Contracts with self-insured employers typically have two to four-year terms. Some of our contracts allow the customer to terminate early.

Our performance-based contracts place a portion of our fees at risk based on achieving certain performance metrics, cost savings, and/or clinical outcomes improvements. Approximately 2% of revenues recorded during the three months ended March 31, 2014 were performance-based and 1% were subject to final reconciliation as of March 31, 2014.

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

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

We generally assess our level of performance for our contracts based on medical claims and other data that the customer is contractually required to supply, interim assessments of achievement against performance targets, or metrics available from our operating platforms. A minimum of four to nine months' data is typically required for us to measure performance. In assessing our performance, we may include estimates such as medical claims incurred but not reported. In addition, we may also provide contractual allowances for billing adjustments (such as data reconciliation differences) as appropriate.

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

During the settlement process under a contract, which generally occurs six to eight months after the end of a contract year, we settle any performance-based fees and reconcile healthcare claims and clinical data. As of March 31, 2014, cumulative performance-based revenues that have not yet been settled with our customers but that have been recognized in the current and prior years totaled approximately $23.2 million, all of which were based on actual data. Data reconciliation differences, for which we provide contractual allowances until we reach agreement with respect to identified issues, can arise between the customer and us due to customer data deficiencies, omissions, and/or data discrepancies.

Performance-related adjustments (including any amounts recorded as revenue that were ultimately refunded), changes in estimates, or data reconciliation differences may cause us to recognize or reverse revenue in a current fiscal year that pertains to services provided during a prior fiscal year. During the three months ended March 31, 2014, we recognized a net increase in revenue of $0.8 million related to services provided prior to 2014.

Impairment of Intangible Assets and Goodwill

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

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

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

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

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

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

Income Taxes

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

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

Share-Based Compensation

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

Results of Operations

The following table shows the components of the consolidated statements of comprehensive income (loss) for the three months ended March 31, 2014 and 2013 expressed as a percentage of revenues.

	Three Months Ended March 31,	
	2014	2013
Revenues	100.0%	100.0%
Cost of services (exclusive of depreciation and amortization included below)	83.8 %	85.5 %
Selling, general and administrative expenses	9.3 %	7.9 %
Depreciation and amortization	7.5 %	8.2 %
Legal settlement charges	5.3 %	-
Operating loss	(5.9)%	(1.6)%
Interest expense	2.5 %	2.0 %
Loss before income taxes [1]	(8.4)%	(3.7)%
Income tax benefit	(3.0)%	(1.3)%
Net loss	(5.4)%	(2.4)%

[1] Figures may not add due to rounding.

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Revenues

Revenues for the three months ended March 31, 2014 increased $11.6 million, or 7.0%, compared to the three months ended March 31, 2013, primarily due to the following:

- the commencement of contracts with new customers and growth with existing customers; and
- an increase in participation in our fitness solutions, as well as in the number of members eligible to participate in such solutions.

These increases were somewhat offset by terminations with certain customers.

Cost of Services

Cost of services (excluding depreciation and amortization) as a percentage of revenues decreased to 83.8% for the three months ended March 31, 2014, compared to 85.5% for the three months ended March 31, 2013, primarily due to the following:

- a decrease in healthcare benefit costs related to a decrease in claims; and
- economies of scale resulting from certain types of costs that remain relatively fixed or do not increase at the same rate as revenues.

These decreases were partially offset by increased costs related to the implementation of a number of new contracts.

Selling, General and Administrative Expenses

Selling, general and administrative expenses as a percentage of revenues increased to 9.3% for the three months ended March 31, 2014 compared to 7.9% for the three months ended March 31, 2013 primarily due to an insurance reimbursement received during the three months ended March 31, 2013 for certain previously incurred legal expenses.

Depreciation and Amortization

Depreciation and amortization expense for the three months ended March 31, 2014 remained relatively consistent with the same period in 2013.

Legal Settlement Charges

On April 17, 2014, we entered into an agreement with BCBSMN to resolve a contractual dispute. As a result of this settlement, we incurred charges of approximately $9.4 million during the three months ended March 31, 2014.

Interest Expense

Interest expense increased $1.1 million for the three months ended March 31, 2014 compared to the same period in 2013, primarily due to amortization of the debt discount related to the Cash Convertible Notes.

Income Tax Expense

Our effective tax benefit rate remained relatively consistent at approximately 36% for the three months ended March 31, 2014 compared to approximately 35% for the three months ended March 31, 2013.

Liquidity and Capital Resources

Operating activities for the three months ended March 31, 2014 provided cash of $9.1 million compared to $26.0 million for the three months ended March 31, 2013, primarily due to the following:

- an increase in days sales outstanding in accounts receivable from 51 days at March 31, 2013 to 58 days at March 31, 2014; and

- the timing of several significant vendor payments.

Investing activities during the three months ended March 31, 2014 used $12.5 million in cash which primarily consisted of capital expenditures associated with our Embrace platform.

Financing activities during the three months ended March 31, 2014 provided $2.6 million in cash primarily due to the difference in net borrowings under the Fifth Amended Credit Agreement between the two periods.

Credit Facility

On June 8, 2012, we entered into the Fifth Amended Credit Agreement. The Fifth Amended Credit Agreement provides us with a $200.0 million revolving credit facility that expires on June 8, 2017 and includes a swingline sub facility of $20.0 million and a $75.0 million sub facility for letters of credit. The Fifth Amended Credit Agreement also provides a $200.0 million term loan facility that matures on June 8, 2017, $107.5 million of which remained outstanding at March 31, 2014, and an uncommitted incremental accordion facility of $200.0 million.

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

On July 1, 2013, we entered into an amendment to the Fifth Amended Credit Agreement, which provided for, among other things, the amendment of certain negative covenants to permit the issuance of and payments related to the Cash Convertible Notes, Cash Convertible Notes Hedges and warrants described below as well as increases in the maximum required levels of total funded debt to EBITDA beginning with the quarter ended June 30, 2013.

On April 15, 2014, in connection with the agreement to resolve the contract dispute with BCBSMN, we entered into an additional amendment to the Fifth Amended Credit Agreement that provides for an add-back to our consolidated EBITDA, which is used for purposes of calculating financial covenants under the Fifth Amended Credit Agreement, for the $9.4 million charge incurred as a result of the settlement of our dispute with BCBSMN. As of March 31, 2014, availability under the revolving credit facility totaled $35.1 million as calculated under the most restrictive covenant.

We are required to repay outstanding revolving loans under the revolving credit facility in full on June 8, 2017. We are required to repay term loans in quarterly principal installments aggregating (1) 1.250% of the original aggregate principal amount of the term loans during each of the eight quarters beginning with the quarter ended September 30, 2012, (2) 1.875% of the original aggregate principal amount of the term loans during each of the next four quarters beginning with the quarter ending September 30, 2014, and (3) 2.500% of the original aggregate principal amount of the term loans during each of the remaining quarters prior to maturity on June 8, 2017, at which time the entire unpaid principal balance of the term loans is due and payable.

The Fifth Amended Credit Agreement contains financial covenants that require us to maintain, as defined, specified ratios or levels at March 31, 2014 of (1) a maximum total funded debt to EBITDA of 4.75 and (2) a minimum total fixed charge coverage of 1.50. As of March 31, 2014, our total funded debt to EBITDA ratio was 4.20, and our total fixed charge coverage ratio was 1.83, each as defined in the Fifth Amended Credit Agreement. We were in compliance with all of the financial covenant requirements of the Fifth Amended Credit Agreement as of March 31, 2014.

The Fifth Amended Credit Agreement contains various other affirmative and negative covenants that are typical for financings of this type. Among other things, the Fifth Amended Credit Agreement limits repurchases of our common stock and the amount of dividends that we can pay to holders of our common stock. A breach of any of these covenants could result in a default under the Fifth Amended Credit Agreement, in which all amounts outstanding under the Fifth Amended Credit Agreement may become immediately due and payable, and all commitments under the Fifth Amended Credit Agreement to extend further credit may be terminated. In addition, a payment default, including an acceleration following an event of default, under the Fifth Amended Credit Agreement or under our indenture for the Cash Convertible Notes, could each trigger an event of default under the other debt instrument, which could result in the principal of and the accrued and unpaid interest on such debt becoming due and payable.

In order to reduce our exposure to interest rate fluctuations on our floating rate debt commitments, we maintain interest rate swap agreements that effectively modify our exposure to interest rate risk by converting a portion of our floating rate debt to fixed obligations, thus reducing the impact of interest rate changes on future interest expense. Under these agreements, we receive a variable rate of interest based on LIBOR, and we pay a fixed rate of interest with interest rates ranging from 0.690% to 1.480% plus a spread (see Note 6 to the consolidated financial statements). We maintain interest rate swap agreements with current notional amounts of $145.0 million and termination dates ranging from November 2015 to December 2016. Of this amount, $95.0 million was effective at March 31, 2014, and $50.0 million will become effective in December 2015, as older interest rate swap agreements expire. We have designated these interest rate swap agreements as qualifying cash flow hedges. We currently meet the hedge accounting criteria under U.S. GAAP in accounting for these interest rate swap agreements.

Cash Convertible Senior Notes

On July 16, 2013, we issued $150.0 million aggregate principal amount of the Cash Convertible Notes due 2018, which bear interest at a rate of 1.50% per year, payable semiannually in arrears on January 1 and July 1 of each year, beginning on January 1, 2014. The Cash Convertible Notes will mature on July 1, 2018, unless earlier repurchased or converted into cash in accordance with their terms prior to such date. The Cash Convertible Notes are convertible into cash based on the conversion rate set forth below and are not convertible into our common stock or any other securities under any circumstances. The initial cash conversion rate is approximately 51.38 shares of our common stock per $1,000 principal amount of Cash Convertible Notes (equivalent to an initial conversion price of approximately $19.46 per share of common stock). The Cash Convertible Notes are our senior unsecured obligations and rank senior in right of payment to any of our indebtedness that is expressly subordinated in right of payment to the Cash Convertible Notes.

In connection with the issuance of the Cash Convertible Notes, we entered into the Cash Convertible Notes Hedges, which are cash-settled and are intended to reduce our exposure to potential cash payments that we would be required to make if holders elect to convert the Cash Convertible Notes at a time when our stock price exceeds the conversion price. The Cash Convertible Notes Hedges, which are recorded and carried at fair value as a derivative asset, are intended to offset the gain (or loss) associated with changes to the valuation of the Cash Conversion Derivative. We also entered into separate privately negotiated Warrants initially relating, in the aggregate, to a notional number of shares of our common stock underlying the Cash Convertible Notes Hedges. The Warrants could have a dilutive effect to the extent that the market price per share of our common stock (as measured under the terms of the warrant transactions) exceeds the applicable strike price of the Warrants. The initial strike price of the Warrants is approximately $25.95 per share, which effectively increases the conversion price of the Cash Convertible Notes to a 60% premium to our stock price on July 1, 2013.

The net proceeds from the sale of the Cash Convertible Notes were approximately $145.3 million, after deducting the initial purchasers' discounts and commissions and the placement expenses. We used $21.6 million of the net proceeds from the sale of the Cash Convertible Notes to pay the cost of the Cash Convertible Notes Hedges (after such cost was partially offset by the proceeds to the Company from the sale of the Warrants), and we used the remainder of the net proceeds from the sale of the Cash Convertible Notes to reduce the outstanding indebtedness under the Fifth Amended Credit Agreement.

Aside from the initial premium paid, we will not be required to make any cash payments under the Cash Convertible Notes Hedges and could be entitled to receive an amount of cash from the option counterparties generally equal to the amount by which the market price per share of common stock exceeds the strike price of the Cash Convertible Note Hedges during the relevant valuation period. The strike price under the Cash Convertible Notes Hedges is initially equal to the conversion price of the Cash Convertible Notes. Additionally, if the market price per share of our common stock exceeds the strike price of the Warrants on any warrant exercise date we will be obligated to issue to the option counterparties a number of shares based on the amount by which the then-current market price per share of our common stock exceeds the then-effective strike price of each Warrant. We will not receive any additional proceeds if the Warrants are exercised.

CareFirst Convertible Note

On October 1, 2013, we entered into an Investment Agreement with CareFirst, which is in addition to certain existing commercial agreements between us and CareFirst relating to, among other things, disease management and care coordination services (the "Commercial Agreements"). Pursuant to the Investment Agreement, we issued the CareFirst Convertible Note in the aggregate original principal amount of $20 million to CareFirst for a purchase price of $20 million. The CareFirst Convertible Note bears interest at a rate of 4.75% per year, payable quarterly in arrears on March 31, June 30, September 30 and December 31 of each calendar year, beginning on December 31, 2013. The CareFirst Convertible Note may be prepaid only under limited circumstances and upon the terms and conditions specified therein. If the CareFirst Convertible Note has not been fully converted or redeemed in accordance with its terms, it will mature on October 1, 2019. The CareFirst Convertible Note is subordinate in right of payment to the prior payment in full of (a) all indebtedness of the Company under the Fifth Amended Credit Agreement, and (b) any other senior debt of the Company, which currently includes only the Cash Convertible Notes.

We believe that cash flows from operating activities, our available cash, and our anticipated available credit under the Fifth Amended Credit Agreement will continue to enable us to meet our contractual obligations and fund our current operations for the foreseeable future. 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 securities to provide the funding for these increased growth opportunities. We may also issue debt or equity securities in connection with future acquisitions or strategic alliances. We cannot assure you that we would be able to issue additional debt or equity securities on terms that would be acceptable to us.

Recently Issued Accounting Standards

In July 2013, the FASB issued ASU No. 2013-11, "Income Taxes (Topic 740)—Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists," which requires an entity to present in the financial statements an unrecognized tax benefit, or a portion of an unrecognized tax benefit, as a reduction to a deferred tax asset resulting from a net operating loss carryforward, a similar tax loss, or a tax credit carryforward. However, when the above situation is not available at the reporting date or the tax law of the applicable jurisdiction does not require the entity to use the deferred tax asset for such purpose, the unrecognized tax benefit should be presented in the financial statements as a liability and should not be combined with deferred tax assets. ASU No. 2013-11 is effective prospectively for reporting periods beginning after December 15, 2013. We adopted this standard for the interim period beginning January 1, 2014. The adoption of this standard did not have a material impact on our consolidated results of operations, financial position, cash flows, or notes to the consolidated financial statements.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

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

In order to reduce our interest rate exposure under the Fifth Amended Credit Agreement, we have entered into interest rate swap agreements effectively converting a portion of our floating rate debt to fixed obligations with interest rates ranging from 0.690% to 1.480% plus a spread.

We estimate that a one-point interest rate change would have resulted in a change in interest expense of approximately $0.1 million for the three months ended March 31, 2014.

As a result of our investment in international initiatives, we are also exposed to foreign currency exchange rate risks. Because a significant portion of these risks is economically hedged with currency options and forwards contracts and because our international initiatives are not yet material to our consolidated results of operations, a 10% change in foreign currency exchange rates would not have had a material impact on our consolidated results of operations, financial position, or cash flows for the three months ended March 31, 2014. We do not execute transactions or hold derivative financial instruments for trading purposes.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our chief executive officer and chief financial officer, has reviewed and evaluated the effectiveness of our "disclosure controls and procedures" (as defined in Rule 13a-15(e) and 15d-15(e) promulgated under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of March 31, 2014. Based on that evaluation, management identified a material weakness in our internal control over financial reporting as of March 31, 2014 related to the revenue recognition process, specifically related to the application of the revenue recognition accounting guidance to new or amended non-standard contracts. As a result of this material weakness, an error was identified in recognizing revenue on an amended non-standard contract. This error was corrected prior to the Company reporting its earnings for the quarter ended March 31, 2014 on April 24, 2014. Solely as a result of this material weakness, our chief executive officer and chief financial officer concluded that, as of the

end of the period covered by this report, the Company's disclosure controls and procedures were not effective.
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To remediate the material weakness in our internal control over financial reporting described above, we have developed and adopted new policies and are implementing the related procedures associated with reviewing the accounting treatment for new or amended non-standard contracts. Specifically, the remediation will include a standard process for preparing contemporaneous documentation of accounting conclusions reached upon our assessments of the pattern for revenue recognition in non-standard customer contracts, additional annual training for appropriate personnel on the accounting treatment of these arrangements, and further centralization of contracting activity.

Changes in Internal Control over Financial Reporting

Except as specifically discussed above in this Item 4, there were no changes in our internal controls over financial reporting during the three months ended March 31, 2014 that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Part II

Item 1. Legal Proceedings

Contract Disputes

On January 25, 2010, Blue Cross Blue Shield of Minnesota issued notice of arbitration with the American Arbitration Association in Minneapolis in accordance with the terms of the contract alleging violations of certain contract provisions and seeking recoupment of an unspecified amount of payments made to us under the contract. We believe we performed our services in compliance with the terms of our agreement and that the assertions made in the arbitration notice are without merit. On August 3, 2011, we asserted numerous counterclaims against BCBSMN. On April 15, 2014, we entered into an agreement with BCBSMN to resolve this dispute. Under the terms of the agreement, we agreed to pay BCBSMN in two separate installments: $4 million by the end of April 2014 and $5.5 million in January 2015. BCBSMN has an option to receive discounts on our well-being improvement services in lieu of the January 2015 payment.

We are involved in a contractual dispute with Plastipak Packaging, Inc. ("Plastipak"). On September 10, 2012, Plastipak filed suit in the Circuit Court for Wayne County, Michigan seeking damages relating to an alleged breach of a services agreement with us. The case is currently in the discovery phase of litigation. We deny Plastipak's claims and intend to vigorously defend the action.

Performance Award Lawsuit

On September 4, 2012, Milton Pfeiffer ("Plaintiff"), claiming to be a stockholder of the Company, filed a putative derivative action against the Company and the Board of Directors (the "Board") in Delaware Chancery Court (the "Court") alleging that the Compensation Committee of the Board and the Board breached their fiduciary duties and violated the Company's 2007 Stock Incentive Plan (the "Plan") by granting Ben R. Leedle, Jr., Chief Executive Officer and President of the Company, discretionary performance awards under the Plan in the form of options to purchase an aggregate of 500,000 shares of the Company's common stock, which consisted of a performance award in November 2011 granting Mr. Leedle the right to purchase 365,000 shares and a performance award in February 2012 granting Mr. Leedle the right to purchase 135,000 shares (the "Performance Awards"). Plaintiff alleges that the Performance Awards exceeded what is authorized by the Plan and that the Company's 2012 proxy statement, in which the Performance Awards are disclosed, is false and misleading. Plaintiff also alleges that Mr. Leedle breached his fiduciary duties and was unjustly enriched by receiving the Performance Awards. Plaintiff is seeking, among other things, the rescission or disgorgement of all alleged "excess" awards granted to Mr. Leedle under the Performance Awards, to recover any incidental damages to the Company, and an award of attorneys' fees and expenses. On November 2, 2012, the Company and the Board filed a Motion to Dismiss because Plaintiff failed to make a demand upon the Board as required by Delaware law. On November 8, 2013, the Court denied the Company's Motion to

Dismiss. On February 21, 2014, the Company filed its answer and intends to vigorously defend the allegations.

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Outlook

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

Item 1A. Risk Factors

In addition to the other information set forth in this report, you should carefully consider the risks and uncertainties previously reported under the caption "Part I — Item 1A. Risk Factors" in our Annual Report on Form 10-K for the fiscal year ended December 31, 2013, the occurrence of which could materially and adversely affect our business, prospects, financial condition and operating results. The risks previously reported and described in our Annual Report on Form 10-K for the fiscal year ended December 31, 2013 and in this report are not the only risks facing our business. Additional risks and uncertainties not currently known to us or those we currently deem to be immaterial may also materially and adversely affect our business operations.

There have been no material changes to our risk factors previously disclosed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2013.

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

Not Applicable.

Item 3. Defaults Upon Senior Securities

Not Applicable.

Item 4. Mine Safety Disclosures

Not Applicable.

Item 5. Other Information

Not Applicable.

Item 6. Exhibits

(a) Exhibits

31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended
31.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended
32	Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema
101.CAL	XBRL Taxonomy Extension Calculation Linkbase
101.DEF	XBRL Taxonomy Extension Definition Linkbase
101.LAB	XBRL Taxonomy Extension Label Linkbase
101.PRE	XBRL Taxonomy Extension Presentation Linkbase

SIGNATURES

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

			Healthways, Inc. (Registrant)
Date	May 9, 2014	By	/s/ Alfred Lumsdaine Alfred Lumsdaine Chief Financial Officer (Principal Financial Officer)