Armour Residential REIT, Inc.
Form 424B5
May 31, 2011

Filed Pursuant to Rule 424(b)(5)

Registration No. 333-173682

The information in this preliminary prospectus supplement and the accompanying prospectus is not complete and may be changed. This preliminary prospectus supplement and the accompanying prospectus are not an offer to sell these securities and are not soliciting an offer to buy these securities in any state where the offer or sale is not permitted

Subject to Completion, Dated May 31, 2011

Prospectus supplement to prospectus dated May 4, 2011

16,000,000 Shares

Common Stock

We are selling 16,000,000 shares of common stock as described in this prospectus supplement and the accompanying prospectus.

Our common stock is traded on the New York Stock Exchange, or NYSE, under the symbol ARR. The closing price of our common stock on the NYSE on May 31, 2011 was $7.64 per share.

We have elected to be taxed as a real estate investment trust, or REIT, for U.S. federal income tax purposes, commencing with our taxable year ended December 31, 2009. To assist us in qualifying as a REIT, among other purposes, stockholders are generally restricted under our charter from beneficially owning more than 9.8% by value or number of shares, whichever is more restrictive, of our outstanding shares of common stock. In addition, our charter contains various other restrictions on the ownership and transfer of our common stock.

Investing in our common stock involves risks. You should carefully consider the risks described under Risk Factors in our most recent Annual Report on Form 10-K, as well as the other information contained or incorporated by reference in this prospectus supplement hereto and the accompanying prospectus before making a decision to invest in our common stock.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined that this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

	Per Share	Total
Public Offering Price	$	$
Underwriting discounts and commissions	$	$
Proceeds, before expenses, to us	$	$

We have granted the underwriters the right to purchase up to 2,400,000 additional shares of common stock.

Deutsche Bank Securities

The date of this prospectus supplement is June , 2011

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PROSPECTUS SUPPLEMENT

PROSPECTUS

You should rely only on the information contained in or incorporated by reference in this prospectus supplement and the accompanying prospectus. We have not authorized anyone to provide you with different information. We are not making an offer of these securities in any state where the offer is not permitted. You

should not assume that the information contained in this prospectus supplement and the accompanying prospectus is accurate as of any date other than the date on the front of this prospectus supplement.

ABOUT THIS PROSPECTUS SUPPLEMENT

This prospectus supplement is a supplement to the accompanying prospectus that is also a part of this document. This prospectus supplement and the accompanying prospectus are part of a registration statement on Form S-3 that we filed with the Securities and Exchange Commission, or SEC or Commission, using a "shelf" registration process. This prospectus supplement contains specific information about us and the terms on which we are offering and selling shares of our common stock. To the extent that any statement made in this prospectus supplement is inconsistent with statements made in the prospectus, the statements made in the prospectus will be deemed modified or superseded by those made in this prospectus supplement. Before you purchase shares of our common stock, you should carefully read this prospectus supplement, the accompanying prospectus and the registration statement, together with the documents incorporated by reference in this prospectus supplement and the accompanying prospectus.

When used in this prospectus supplement or the accompanying prospectus, the terms “ARMOUR,” “company,” “issuer,” “registrant,” “we,” “our,” and “us” refer to ARMOUR Residential REIT, Inc., unless otherwise specified.

SPECIAL NOTE REGARDING FORWARD–LOOKING STATEMENTS

This prospectus supplement and the accompanying prospectus contain various forward-looking statements. Forward-looking statements relate to expectations, beliefs, projections, future plans and strategies, anticipated events or trends and similar expressions concerning matters that are not historical facts. In some cases, you can identify forward-looking statements by the use of forward-looking terminology such as believes, expects, may, will, woul could, should, seeks, approximately, intends, plans, projects, estimates or anticipates or the negative and phrases or similar words or phrases. All forward-looking statements may be impacted by a number of risks and uncertainties, including statements regarding the following subjects:

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our business and investment strategy;

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our anticipated results of operations;

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statements about future dividends;

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our ability to obtain financing arrangements;

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our understanding of our competition and ability to compete effectively;

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market, industry and economic trends; and

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interest rates.

The forward-looking statements in this prospectus supplement and the accompanying prospectus are based on our beliefs, assumptions and expectations of our future performance, taking into account all information currently available to us. These beliefs, assumptions and expectations are subject to risks and uncertainties and can change as a result of many possible events or factors, not all of which are known to us. If a change occurs, our business, financial condition, liquidity and results of operations may vary materially from those expressed in our forward-looking statements. You should carefully consider these risks before you make an investment decision with respect to our common stock, along with the following factors that could cause actual results to vary from our forward-looking statements:

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the factors referenced in this prospectus, including those set forth under the section captioned Risk Factors ;

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the federal conservatorship of Fannie Mae and Freddie Mac and related efforts, along with any changes in laws and regulations affecting the relationship between Fannie Mae and Freddie Mac and the federal government;

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mortgage loan modification programs and future legislative action;

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availability, terms and deployment of capital;

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changes in economic conditions generally;

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changes in interest rates, interest rate spreads, the yield curve or prepayment rates;

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general volatility of the financial markets, including markets for mortgage securities;

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inflation or deflation;

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availability of suitable investment opportunities;

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the degree and nature of our competition, including competition for agency securities from the U.S. Treasury;

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changes in our business and investment strategy;

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our limited operating history;

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our dependence on our manager and ability to find a suitable replacement if our manager were to terminate its management relationship with us;

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the existence of conflicts of interest in our relationship with our manager, certain of our directors and our officers, which could result in decisions that are not in the best interest of our stockholders;

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changes in personnel at our manager or the availability of qualified personnel at our manager;

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limitations imposed on our business by our status as a REIT;

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changes in GAAP, including interpretations thereof; and

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changes in applicable laws and regulations.

We cannot guarantee future results, levels of activity, performance or achievements. You should not place undue reliance on forward-looking statements, which apply only as of the date of this prospectus. We do not intend and disclaim any duty or obligation to update or revise any industry information or forward-looking statements set forth in this prospectus supplement to reflect new information, future events or otherwise, except as required under the U.S. federal securities laws.

PROSPECTUS SUPPLEMENT SUMMARY

This summary highlights the material information contained in this prospectus supplement. It does not contain all of the information that you should consider before investing in our common stock. You should read carefully the more detailed information set forth under Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2010 and the other information included in this prospectus supplement. Except where the context suggests otherwise, references to we , us , ARMOUR or the Company are to ARMOUR Residential REIT, Inc. Except as otherwise indicated, the information in this prospectus supplement assumes no exercise of the underwriters' overallotment option.

Overview

We are a Maryland corporation that has elected to be a real estate investment trust, or REIT, for U.S. federal income tax purposes, commencing with our fiscal year ended December 31, 2009. We are externally managed by ARMOUR Residential Management LLC, or ARRM, an entity affiliated with our executive officers. We invest primarily in hybrid adjustable rate, adjustable rate and fixed rate residential mortgage-backed securities, or RMBS, issued or guaranteed by U.S. Government-chartered entities, which we refer to as Agency Securities. The entities issuing or guaranteeing the Agency Securities include:

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the Federal National Mortgage Association, commonly known as Fannie Mae;

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the Federal Home Loan Mortgage Corporation, commonly known as Freddie Mac; and

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the Government National Mortgage Administration, commonly known as Ginnie Mae.

From time to time, a portion of our portfolio may be invested in unsecured notes and bonds issued by U.S. Government-chartered entities, which we refer to as Agency Debt. Agency Debt includes:

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U.S. Treasuries; and

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money market instruments.

We seek attractive long-term investment returns by investing our equity capital and borrowed funds in our targeted asset class. We earn returns on the spread between the yield on our assets and our costs, including the interest cost of the funds we borrow, after giving effect to our hedges.

When acquiring Agency Securities, we typically finance our acquisitions with borrowings under a series of short-term repurchase agreements at the most competitive interest rates available to us and then cost-effectively mitigate our interest rate and other risks based on our entire portfolio of assets, liabilities and derivatives and our management's view of the market. Successful implementation of this approach requires us to address and effectively mitigate interest rate risk and maintain adequate liquidity.

Recent Developments

Since March 31, 2010, we have completed one additional underwritten follow-on public offering for an aggregate of 17,000,000 shares of common stock. Net proceeds from this offering were approximately $121.4 million and were used to acquire additional target assets.

On April 4, 2011, the listing of our common stock was transferred from the NYSE Amex to the NYSE.

On April 7, 2011, a registration statement we filed on March 24, 2011 to register 4,000,000 shares of our common stock for issuance under our Dividend Reinvestment and Stock Purchase Plan was declared effective.

On April 22, 2011, we filed a registration statement to increase our universal shelf registration to $1.0 billion. The registration statement was declared effective on May 4, 2011.

On April 28, 2011 and May 27, 2011, we paid monthly dividends of $0.12. Such dividends were declared on March 10, 2011, when we declared a monthly dividend of $0.12 payable to stockholders for each month in the second fiscal quarter of 2011.

On May 2, 2011, our board of directors adopted a resolution to amend our articles of incorporation to broaden our investment asset class restriction to include non-Agency Securities as well as Agency Securities. This amendment is subject to stockholder approval. While we are fully committed to continue investing primarily in Agency Securities for as long as appropriate supply and pricing exist, our board believes that we need to revise our investment asset class restriction to allow us to continue investing in the high credit-quality RMBS market in the event that Congress acts to eliminate or reduce the role of U.S. Government-chartered entities in the RMBS market. ARRM s ability to modify or expand our investment strategy in response to changing market conditions may ultimately be constrained by the outcome of our stockholders vote on this matter.

As of May 5, 2011, after the full deployment of our offering proceeds, our Agency Securities portfolio was valued at approximately $3.4 billion, compared with a value of approximately $2.3 billion as of March 31, 2011. As of May 5, 2011, our total repurchase indebtedness was approximately $3.2 billion, compared with repurchase indebtedness of approximately $2.1 million on March 31, 2011.

During the period from April 25, 2011 to May 27, 2011, we issued and sold a total of 1,721,078 shares of common stock at an average price of $7.45 per share under our Dividend Reinvestment and Stock Purchase Plan.

Corporate Information

We were incorporated in the state of Maryland on February 5, 2008. On November 1, 2009, we consummated a business combination with Enterprise Acquisition Corp., a publicly traded blank check company formed for the purposes of acquiring an operating business. As a result of this transaction, which we refer to as the Business Combination, we became a publicly traded company.

Our principal offices are located at 3001 Ocean Drive, Suite 201, Vero Beach, Florida 32963. Our phone number is (772) 617-4340. Our website is www.ARMOURREIT.com. The contents of our website are not a part of this prospectus supplement or the accompanying prospectus. The information on our website is not intended to form a part of or be incorporated by reference into this prospectus supplement or the accompanying prospectus.

The Offering

Common Stock Offered By Us	16,000,000 shares
Common stock to be outstanding after this offering	66,981,155 shares
	We also have outstanding redeemable warrants to purchase an aggregate of 32,500,000 shares of our common stock that are currently exercisable through November 7, 2013 at an exercise price of $11.00 per share. These warrants likely will be exercised if the market price of the shares of our common stock equals or exceeds the warrant exercise price.
Use of Proceeds	We plan to use all of the net proceeds from this offering to acquire additional target assets, principally Agency Securities and Agency Debt, in accordance with our objectives and strategies described in this prospectus. See Use of Proceeds.
Dividend Policy	We intend to continue to make regular cash distributions to holders of our common stock consistent with maintaining our REIT qualification for U.S. federal income tax law purposes. Prior to January 2011, our distributions have been in the form of quarterly cash dividends. However, commencing in January 2011, we began paying cash dividends to our stockholders on a monthly, rather than on a quarterly, basis.
	On January 28, 2011, February 25, 2011 and March 30, 2011, we paid monthly dividends of $0.12. In addition, on March 10, 2011, we declared a monthly dividend of $0.12 payable to stockholders for each month in the second fiscal quarter of 2011. On April 28, 2011 and May 27,2011, we paid monthly dividends of $0.12
Listing	Our common stock is traded on the NYSE under the symbol ARR.
Ownership Restrictions	To assist us in qualifying as a REIT, ownership of shares of our common stock by any person is limited, with certain exceptions, to 9.8% by value or by number of shares, whichever

	is more restrictive, of our outstanding shares of common stock. Our charter also provides for certain other ownership restrictions. We have granted waivers from the 9.8% charter restriction for certain equity holders where, based on representations, covenants and agreements received from such holders, we determined that such waivers would not jeopardize our status as a REIT.
Risk Factors	Investing in our common stock involves risks. You should carefully consider the risks described under Risk Factors in our most recent Annual Report on Form 10-K as well as the other information contained or incorporated by reference in this prospectus supplement and the accompanying prospectus before making a decision to invest in our common stock.

USE OF PROCEEDS

We are offering 16,000,000 shares of our common stock at a public offering price of $ per share. We estimate that the net proceeds we will receive from selling common stock in this offering will be approximately after deducting underwriting discounts and commissions payable by us and estimated offering expenses of approximately $.

We plan to use all the net proceeds from this offering to acquire additional target assets in accordance with our objectives and strategies described in this prospectus. Our focus will be on purchasing Agency Securities and Agency Debt and other assets, subject to our investment guidelines and REIT qualification requirements. ARRM will make determinations as to the percentage of our assets that will be invested in each of our target assets. Its decisions will depend on prevailing market conditions and may change over time in response to opportunities available in different interest rate, economic and credit environments. Until appropriate assets can be identified, ARRM may invest the net proceeds from this offering in interest-bearing short-term investments, including funds that are consistent with our qualification as a REIT. These investments are expected to provide a lower net return than we will seek to achieve from our target assets. Prior to the time we have fully used the net proceeds of this offering to acquire our target assets, we may fund our quarterly cash distributions out of such net proceeds.

CAPITALIZATION

The following table sets forth (1) our actual capitalization at March 31, 2011, (2) our capitalization on a pro forma basis to reflect the effect of (i) the sale of 17,000,000 shares of our common stock in an underwritten public offering on April 8, 2011 at a public offering price of $7.40 per share, after deducting the underwriting discount and estimated expenses paid by us, (ii) the sale of 1,721,078 shares of our common stock at an average price of $7.45 per share under our Dividend Reinvestment and Stock Purchase Plan, and (iii) the issuance of 6,023 shares of our common stock under our Stock Incentive Plan, and (3) our pro forma capitalization as adjusted to reflect the effect of the sale of 16,000,000 shares of our common stock in this offering at a public offering price of $ per share, after deducting the underwriting discount and estimated offering expenses payable by us. You should read this table together with our consolidated financial statements and the accompanying notes, and Management's Discussion and Analysis of Financial Condition and Results of Operations and Use of Proceeds included elsewhere in the accompanying prospectus.

	At March 31, 2011 (dollars in thousands)		
	Actual*	**Pro Forma (unaudited)**	**Pro Forma As Adjusted**
Cash	$ 47,174	$ 181,279	$
Stockholders' equity			
Common stock, $0.001 par value; 250,000,000 shares authorized; 32,254,054 shares outstanding, actual; 50,981,155 shares outstanding, pro forma; and shares outstanding, as adjusted for the sale of the 16,000,000 shares in this offering	32	51	
Additional paid-in capital	229,733	363,820	
Accumulated deficit	(4,678)	(4,678)	(4,678)
Accumulated other comprehensive (loss)	(4,475)	(4,475)	(4,475)
Total capitalization	$ 220,612	$ 354,718	$

* Amounts are derived from the March 31, 2011 unaudited condensed consolidated financial statements.

UNDERWRITING

Subject to the terms and conditions of the underwriting agreement, the underwriters named below, through their representative Deutsche Bank Securities Inc., have severally agreed to purchase from us the following respective number of our shares of common stock at the public offering price less the underwriting discounts and commissions set forth on the cover page of this prospectus supplement:

Underwriters	**Number of Shares**
Deutsche Bank Securities Inc.	
Total	16,000,000

The underwriting agreement provides that the obligations of the several underwriters to purchase the shares offered hereby is subject to certain conditions precedent and that the underwriter will purchase all of the shares offered by this prospectus supplement, other than those covered by the option to purchase additional shares described below, if any of these shares are purchased.

We have been advised by the representative of the underwriters that the underwriters propose to offer the shares to the public at the public offering price set forth on the cover of this prospectus supplement and to dealers at a price that represents a concession not in excess of $ per share under the public offering price. The underwriters may allow, and these dealers may re-allow, a concession of not more than $ per share to other dealers. If all the shares are not sold at the public offering price, the underwriter may change the offering price and other selling terms.

We have granted to the underwriters an option to purchase up to 2,400,000 additional shares exercisable, in whole or in part, at any time until 30 days after the date of this prospectus supplement, at the public offering price less the underwriting discounts and commissions set forth on the cover page of this prospectus supplement. To the extent that the underwriters exercise this option, each of the underwriters will become obligated, subject to conditions, to purchase approximately the same percentage of these additional shares as the number of shares to be purchased by it in the above table bears to the total number of shares offered by this prospectus supplement. We will be obligated, pursuant to the option, to sell these additional shares to the underwriters to the extent the option is exercised. If any additional shares are purchased, the underwriters will offer the additional shares on the same terms as those on which the 16,000,000 shares are being offered.

The underwriting discounts and commissions per share are equal to the public offering price per share less the amount paid by the underwriters to us per share. We have agreed to pay the underwriters the following discounts and commissions, assuming either no exercise or full exercise of the underwriters option to purchase additional shares:

		Total Fees	
	Fee per share	**Without Exercise of Underwriter s Option**	**With Full Exercise of Underwriter s Option**
Discounts and commissions paid by us	$	$	$

In addition, we estimate that our share of the total expenses of this offering, excluding underwriting discounts and commissions, will be approximately $ 150,000.

We have agreed to indemnify the underwriters against some specified types of liabilities, including liabilities under the Securities Act, and to contribute to payments the underwriters may be required to make in respect of any of these liabilities.

We and each of our executive officers and directors has agreed not to, directly or indirectly, offer, sell, pledge, contract to sell, grant any option to purchase or otherwise dispose of, or enter into any transaction that is designed to or reasonably expected to lead to or result in the disposition of any of our shares or other securities convertible into or exchangeable or exercisable for our common shares or derivatives of our shares owned by these persons prior to this offering for a period of 30 days after the date of this prospectus supplement without the prior written consent of the representative. This consent may be given at any time without public notice. We have entered into a similar agreement with the representative, but our agreement will not apply in respect of shares we may issue under our existing equity incentive plan or under our existing dividend reinvestment and share purchase program.

Notwithstanding the foregoing, if, subject to certain exceptions, (i) during the last 17 days of the 30-day restricted period we release earnings results or material news or a material event relating to us occurs, or (ii) prior to the expiration of the 30-day restricted period, we announce that we will release earnings results during the 16-day period following the last day of the 30-day period, the above restrictions continue to apply until the expiration of the 18-day period beginning on the date of the release of the earnings results or the occurrence of the material news or event.

The representative of the underwriters has advised us that the underwriters do not intend to confirm sales to any account over which they exercise discretionary authority.

In connection with the offering, the underwriters may purchase and sell our shares in the open market. These transactions may include short sales, purchases to cover positions created by short sales and stabilizing transactions.

Short sales involve the sale by the underwriters of a greater number of shares than they are required to purchase in the offering. Covered short sales are sales made in an amount not greater than the underwriters option to purchase additional shares from us in the offering. The underwriters may close out any covered short position by either exercising their option to purchase additional shares or purchasing shares in the open market. In determining the source of shares to close out the covered short position, the underwriters will consider, among other things, the price of shares available for purchase in the open market as compared to the price at which they may purchase shares through the underwriters option.

Naked short sales are any sales in excess of the option to purchase additional shares. The underwriters must close out any naked short position by purchasing shares in the open market. A naked short position is more likely to be created if the underwriters are concerned that there may be downward pressure on the price of the shares in the open market prior to the completion of the offering.

Stabilizing transactions consist of various bids for or purchases of our shares made by the underwriters in the open market prior to the completion of the offering.

Purchases to cover a short position and stabilizing transactions may have the effect of preventing or slowing a decline in the market price of our shares. Additionally, these purchases, along with the imposition of the penalty bid, may stabilize, maintain or otherwise affect the market price of our shares. As a result, the price of our shares may be higher than the price that might otherwise exist in the open market. These transactions may be effected on the NYSE, in the over-the-counter market or otherwise.

This prospectus supplement and the accompanying prospectus may be made available in electronic format on Internet websites maintained by one or more of the lead underwriters of this offering and may be made available on websites maintained by other underwriters. Other than this prospectus supplement and the accompanying prospectus, in electronic format, the information on any underwriter s website and any information contained in any other website maintained by an underwriter is not part of this prospectus supplement or the accompanying prospectus, or the registration statement of which the accompanying prospectus and this prospectus supplement form a part.

Some of the underwriters and their affiliates have engaged in, and may in the future engage in, investment banking, lending, and other commercial dealings in the ordinary course of business with us. They receive customary fees and commissions for these services.

Selling Restrictions

No action has been taken in any jurisdiction (except in the United States) that would permit a public offering of the shares, or the possession, circulation or distribution of this prospectus supplement, the accompanying prospectus or any other material relating to us or the shares where action for that purpose is required. Accordingly, the shares may not be offered or sold, directly or indirectly, and neither this prospectus supplement, the accompanying prospectus nor any other offering material or advertisements in connection with the shares may be distributed or published, in or from any country or jurisdiction except in compliance with any applicable rules and regulations of any such country or jurisdiction.

The underwriters may arrange to sell the shares offered hereby in certain jurisdictions outside the United States, either directly or through affiliates, where it is permitted to do so.

European Economic Area

In relation to each Member State of the European Economic Area (the EEA) that has implemented the Prospectus Directive, as defined below (each, a Relevant Member State), an offer to the public of any shares that are the subject of the offering contemplated in this prospectus supplement may not be made in that Relevant Member State, except that an offer to the public in that Relevant Member State of any of the shares may be made at any time under the following exemptions under the Prospectus Directive, if they have been implemented in that Relevant Member State:

(a) at any time to any legal entity which is a qualified investor as defined in the Prospectus Directive;

(b) by the underwriters to fewer than 100 or, if the Relevant Member State has implemented the relevant provisions of the 2010 PD Amending Directive, 150 natural or legal persons (other than qualified investors, as defined in the Prospectus Directive), as permitted under the Prospectus Directive, subject to obtaining the prior consent of the underwriter for any such offer; or

(c) in any other circumstances falling within Article 3(2) of the Prospectus Directive,

provided that no such offer of the shares shall result in a requirement for us or the underwriter to publish a prospectus pursuant to Article 3 of the Prospectus Directive.

Any person making or intending to make any offer within the EEA of the shares that are the subject of the offering contemplated in this prospectus supplement and the accompanying prospectus should only do so in circumstances in which no obligation arises for us or the underwriter to produce a prospectus for such offer. Neither we nor the underwriters has authorized, or will authorize, the making of any offer of the shares offered hereby through any financial intermediary, other than offers made by the underwriters that constitute the final offering of the securities contemplated in this prospectus supplement and the accompanying prospectus.

For the purposes of this provision and the buyer s representation below, the expression an offer of securities to the public in relation to the shares in any Relevant Member State means the communication in any form and by any means of sufficient information on the terms of the offer and the shares to be offered so as to enable an investor to decide to purchase the shares, as the same may be varied in that Relevant Member State by any measure implementing the Prospectus Directive in that Relevant Member State and the expression Prospectus Directive means Directive 2003/71/EC (and amendments thereto, including the 2010 PD Amending Directive to the extent implemented in the Relevant Member State) and includes any relevant implementing measure in each Relevant Member State and the expression 2010 PD Amending Directive means Directive 2010/73/EU.

Each person in a Relevant Member State who receives any communication in respect of, or who acquires any of the shares that are the subject of the offering contemplated by this prospectus supplement and the accompanying prospectus will be deemed to have represented, warranted and agreed to and with the underwriter and us that:

(a) it is a qualified investor within the meaning of the law in that Relevant Member State implementing Article 2(1)(e) of the Prospectus Directive; and

(b) in the case of any shares acquired by it as a financial intermediary, as that term is used in Article 3(2) of the Prospectus Directive, (i) the shares acquired by it in the offering have not been acquired on behalf of, nor have they been acquired with a view to their offer or resale to, persons in any Relevant Member State other than qualified investors, as defined in the Prospectus Directive, or in circumstances in which the prior consent of the underwriter has been given to the offer or resale; or (ii) where the shares have been acquired by it on behalf of persons in any Relevant Member State other than qualified investors, the offer of those shares to it is not treated under the Prospectus Directive as having been made to such persons.

United Kingdom

Any invitation or inducement to engage in investment activity (within the meaning of Section 21 of the Financial Services and Markets Act 2000 (the FSMA)), in connection with the issue or sale of the shares, has only been, and will only be, communicated or caused to be communicated in circumstances in which Section 21(1) of the FSMA does not apply to us.

Anything in relation to the shares in, from or otherwise involving the United Kingdom, has been, and may only be done, in compliance with all applicable provisions of the FSMA.

Switzerland

We have not and will not register with the Swiss Financial Market Supervisory Authority (FINMA) as a foreign collective investment scheme pursuant to Article 119 of the Federal Act on Collective Investment Scheme of June 23, 2006, as amended (CISA), and accordingly, the shares being offered pursuant to this prospectus supplement and the accompanying prospectus have not and will not be approved, and may not be licenseable, with FINMA. Therefore, the shares have not been authorized for distribution by FINMA as a foreign collective investment scheme pursuant to Article 119 CISA and the shares offered hereby may not be offered to the public (as this term is defined in Article 3 CISA) in or from Switzerland. The shares may solely be offered to qualified investors, as this term is defined in Article 10 CISA, and in the circumstances set out in Article 3 of the Ordinance on Collective Investment Scheme of November 22, 2006, as amended (CISO), such that there is no public offer.

Investors, however, do not benefit from protection under CISA or CISO or supervision by FINMA. This prospectus supplement and the accompanying prospectus and any other materials relating to the shares are strictly personal and confidential to each offeree and do not constitute an offer to any other person. This prospectus supplement and the accompanying prospectus may only be used by those qualified investors to whom they have been handed out in connection with the offer described herein and may neither directly or indirectly be distributed or made available to any person or entity other than their recipients. They may not be used in connection with any other offer and shall in particular not be copied and/or distributed to the public in Switzerland or from Switzerland. This prospectus supplement and the accompanying prospectus do not constitute an issue prospectus as that term is understood pursuant to Article 652a and/or 1156 of the Swiss Federal Code of Obligations. We have not applied for a listing of the shares on the SIX Swiss Exchange or any other regulated securities market in Switzerland, and consequently, the information presented in this prospectus supplement and the accompanying prospectus does not necessarily comply with the information standards set out in the listing rules of the SIX Swiss Exchange and corresponding prospectus schemes annexed to the listing rules of the SIX Swiss Exchange.

Dubai International Financial Centre

This prospectus supplement and the accompanying prospectus relate to an exempt offer in accordance with the Offered Securities Rules of the Dubai Financial Services Authority. This prospectus supplement and the accompanying prospectus is intended for distribution only to persons of a type specified in those rules. They must not be delivered to, or relied on by, any other person. The Dubai Financial Services Authority has no responsibility for reviewing or verifying any documents in connection with exempt offers. The Dubai Financial Services Authority has not approved this prospectus supplement and the accompanying prospectus nor taken steps to verify the information set out herein and therein, and has no responsibility for them. The shares that are the subject of the offering contemplated by this prospectus supplement and the accompanying prospectus may be illiquid and/or subject to restrictions on their resale. Prospective purchasers of the shares offered hereby should conduct their own due diligence on the shares. If you do not understand the contents of this prospectus supplement and the accompanying prospectus, you should consult an authorized financial adviser.

Hong Kong

The shares may not be offered or sold in Hong Kong by means of any document other than (i) in circumstances that do not constitute an offer to the public within the meaning of the Companies Ordinance (Cap. 32, Laws of Hong Kong), or (ii) to professional investors within the meaning of the Securities and Futures Ordinance (Cap. 571, Laws of Hong Kong) and any rules made thereunder, or (iii) in other circumstances which do not result in the document being a prospectus within the meaning of the Companies Ordinance (Cap. 32, Laws of Hong Kong) and no advertisement, invitation or document relating to the shares may be issued or may be in the possession of any person for the purpose of issue (in each case whether in Hong Kong or elsewhere), which is directed at, or the contents of which are likely to be accessed or read by, the public in Hong Kong (except if permitted to do so under the laws of Hong Kong) other than with respect to shares which are or are intended to be disposed of only to persons outside Hong Kong or only to professional investors within the meaning of the Securities and Futures Ordinance (Cap. 571, Laws of Hong Kong) and any rules made thereunder.

Japan

The shares offered in this prospectus supplement have not been registered under the Financial Instruments and Exchange Law of Japan. The shares have not been offered or sold and will not be offered or sold, directly or indirectly, in Japan or to, or for the benefit of, any resident of Japan or to others for re-offering or re-sale, directly or indirectly, in Japan or to a resident of Japan, except (i) pursuant to an exemption from the registration requirements of the Financial Instruments and Exchange Law and (ii) in compliance with any other applicable requirements of Japanese law.

Singapore

Neither this prospectus supplement nor the accompanying prospectus has been registered as a prospectus with the Monetary Authority of Singapore. Accordingly, this prospectus supplement, the accompanying prospectus and any other document or material in connection with the offer or sale, or invitation for subscription or purchase, of the common shares may not be circulated or distributed, nor may the common shares be offered or sold, or be made the subject of an invitation for subscription or purchase, whether directly or indirectly, to persons in Singapore other than (i) to an institutional investor under Section 274 of the Securities and Futures Act, Chapter 289 of Singapore (the SFA), (ii) to a relevant person pursuant to Section 275(1), or any person pursuant to Section 275(1A), and in accordance with the conditions specified in Section 275 of the SFA or (iii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA, in each case subject to compliance with conditions set forth in the SFA.

Where the common shares are subscribed or purchased under Section 275 of the SFA by a relevant person which is: (a) a corporation (which is not an accredited investor (as defined in Section 4A of the SFA)) the sole business of which is to hold investments and the entire share capital of which is owned by one or more individuals, each of whom is an accredited investor; or (b) a trust (where the trustee is not an accredited investor) whose sole purpose is to hold investments and each beneficiary of the trust is an individual who is an accredited investor, shares, debentures and units of shares and debentures of that corporation or the beneficiaries rights and interest (however described) in that trust shall not be transferred within six months after that corporation or that trust has acquired the common shares pursuant to an offer made under Section 275 of the SFA except: (1) to an institutional investor (for corporations, under Section 274 of the SFA) or to a relevant person defined in Section 275(2) of the SFA, or to any person pursuant to an offer that is made on terms that such shares, debentures and units of shares and debentures of that corporation or such rights and interest in that trust are acquired at a consideration of not less than S$200,000 (or its equivalent in a foreign currency) for each transaction, whether such amount is to be paid for in cash or by exchange of securities or other assets, and further for corporations, in accordance with the conditions specified in Section 275 of the SFA; (2) where no consideration is or will be given for the transfer; or (3) where the transfer is by operation of law.

SUPPLEMENT TO U.S. FEDERAL INCOME TAX CONSIDERATIONS

The following summary of certain U.S. Federal income tax considerations supplements the discussion set forth under the heading U.S. Federal Income Tax Considerations in the accompanying prospectus and is for general information only and is not tax advice. This discussion does not purport to deal with all aspects of taxation that may be relevant to particular holders of our common stock in light of their personal investment or tax circumstances.

EACH PROSPECTIVE HOLDER IS ADVISED TO CONSULT HIS OR HER TAX ADVISOR REGARDING THE SPECIFIC FEDERAL, STATE, LOCAL, AND FOREIGN INCOME AND OTHER TAX CONSEQUENCES TO HIM OR HER OF ACQUIRING, HOLDING, EXCHANGING, OR OTHERWISE DISPOSING OF OUR COMMON STOCK AND OF OUR ELECTION TO BE TAXED AS A REAL ESTATE INVESTMENT TRUST, AND OF POTENTIAL CHANGES IN APPLICABLE TAX LAWS.

Legislative or Other Actions Affecting REITs

The present federal income tax treatment of REITs may be modified, possibly with retroactive effect, by legislative, judicial or administrative action at any time. The REIT rules are constantly under review by persons involved in the legislative process and by the Internal Revenue Service and the U.S. Treasury Department which may result in statutory changes as well as revisions to regulations and interpretations. Recent tax legislation extends the 2001 and 2003 tax rates for non-corporate taxpayers through 2012, including the maximum 35% tax rate on ordinary income and the maximum 15% tax rate for long-term capital gains and qualified dividend income. As noted in the accompanying prospectus, dividends paid by REITs will generally not constitute qualified dividend income eligible for the 15% tax rate for non-corporate domestic stockholders and will generally be taxable at the higher ordinary income tax rates.

In addition, under recent tax legislation, after December 31, 2012, withholding at a rate of 30% will be required on dividends in respect of, and gross proceeds from the sale of, shares of our stock held by or through certain foreign financial institutions (including investment funds), unless such institution enters into an agreement with the Secretary of the Treasury to report, on an annual basis, information with respect to shares in, and accounts maintained by, the institution to the extent such shares or accounts are held by certain U.S. persons or by certain non-U.S. entities that are wholly or partially owned by U.S. persons. Accordingly, the entity through which our shares are held will affect the determination of whether such withholding is required. Similarly, dividends in respect of, and gross proceeds from the sale of, our shares held by an investor that is a non-financial non-U.S. entity will be subject to withholding at a rate of 30%, unless such entity either (i) certifies to us that such entity does not have any "substantial U.S. owners" or (ii) provides certain information regarding the entity's "substantial U.S. owners," which we will in turn provide to the Secretary of the Treasury. Non-U.S. stockholders are encouraged to consult with their tax advisers regarding the possible implications of these rules on their investment in our stock.

LEGAL MATTERS

Certain legal matters will be passed upon for us by Akerman Senterfitt, Miami, Florida. In addition, the description of U.S. federal income tax consequences contained in the section of the accompanying prospectus to this prospectus supplement entitled U.S. Federal Income Tax Considerations is based on the opinion of Akerman Senterfitt, Miami, Florida. Certain legal matters relating to this offering will be passed upon for the underwriters by Skadden, Arps, Slate, Meagher & Flom LLP, New York, New York.

EXPERTS

The consolidated balance sheets of ARMOUR Residential REIT, Inc. and subsidiaries as of December 31, 2010 and 2009 and the related consolidated statements of operations, stockholders equity, and cash flows for the years ended December 31, 2010, 2009 and 2008 have been audited by EisnerAmper LLP, independent registered public accounting firm, as stated in their report, which report is included in this registration statement and prospectus by incorporation in reliance upon the report of EisnerAmper LLP, given upon their authority as experts in accounting and auditing.

PROSPECTUS

ARMOUR Residential REIT, Inc.

$1,000,000,000

Common Stock

Preferred Stock

Warrants

Debt Securities

Depositary Shares

We may offer, issue and sell, from time to time, up to an aggregate of $1,000,000,000 of shares of our common stock, preferred stock, warrants, depositary shares and debt securities, which may consist of debentures, notes, or other types of debt, in one or more offerings. We will provide specific terms of each issuance of these securities in supplements to this prospectus. We may offer and sell these securities to or through one or more underwriters, dealers and agents, or directly to purchasers, on a continuous or delayed basis. You should read this prospectus and any supplement carefully before you decide to invest. This prospectus may not be used to consummate sales of these securities unless it is accompanied by a prospectus supplement.

Our common stock and warrants are listed on the New York Stock Exchange (NYSE) and the NYSE Amex under the symbols ARR and ARR.WS, respectively.

We have elected to be taxed as a real estate investment trust, or REIT, for U.S. federal income tax purposes, commencing with our taxable year ended December 31, 2009. To assist us in qualifying as a REIT, among other purposes, stockholders are generally restricted under our charter from beneficially owning more than 9.8% by value or number of shares, whichever is more restrictive, of our outstanding shares of common stock. In addition, our charter contains various other restrictions on the ownership and transfer of our common stock.

Our principal office is located at 3001 Ocean Drive, Suite 201, Vero Beach, Florida 32963. Our telephone number is (772) 617-4340.

Investing in our securities involves risks. You should carefully consider the information referred to under the heading *Risk Factors* beginning on page 6 of this prospectus before you invest.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined that this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

The date of this prospectus is May 4, 2011

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You should rely only on the information contained in this document or to which we have referred you. We have not authorized anyone to provide you with information that is different. This document may only be used where it is legal to sell these securities. The information in this document may only be accurate on the date of this document.

ABOUT THIS PROSPECTUS

This prospectus is part of a registration statement that we filed with the Securities and Exchange Commission, or SEC or Commission, using a shelf registration process. Under this shelf registration process, we may sell the securities described in this prospectus in one or more offerings. This prospectus provides you with a general description of the securities we may offer. Each time we offer to sell securities, we will provide a supplement to this prospectus that will contain specific information about the terms of that offering. The prospectus supplement may also add, update or change information contained in this prospectus. It is important for you to consider the information contained in this prospectus and any prospectus supplement together with additional information described under the headings *Where You Can Find More Information* and *"Incorporation of Certain Documents by Reference."*

You should rely only on the information incorporated by reference or set forth in this prospectus or the applicable prospectus supplement. We have not authorized anyone else to provide you with additional or different information. You should not assume that the information in this prospectus, the applicable prospectus supplement or any other offering material is accurate as of any date other than the dates on the front of those documents.

When used in this prospectus, the terms ARMOUR, company, issuer, registrant, we, our, and us refer to A Residential REIT, Inc., unless otherwise specified.

SPECIAL NOTE REGARDING FORWARD–LOOKING STATEMENTS

This prospectus contains various “forward-looking statements.” Forward-looking statements relate to expectations, beliefs, projections, future plans and strategies, anticipated events or trends and similar expressions concerning matters that are not historical facts. In some cases, you can identify forward-looking statements by the use of forward-looking terminology such as believes, expects, may, will, would, could, should, seeks, appro intends, plans, projects, estimates or anticipates or the negative of these words and phrases or similar words or phrases. All forward-looking statements may be impacted by a number of risks and uncertainties, including statements regarding the following subjects:

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our business and investment strategy;

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our anticipated results of operations;

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statements about future dividends;

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our ability to obtain financing arrangements;

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A significant portion of our business is subject to renewal each year. Therefore, renewals have a significant impact on our revenue and operating results.

For the year ended December 31, 2016, approximately 71% of our net revenue was derived from our workforce subscription-based solution products. Our subscription-based customers have no obligation to renew their subscriptions for our products or services after the expiration of the subscription agreement, and in fact, some customers have elected not to renew their subscription. In addition, our customers may renew at a lower pricing or activity level. Our customers renewals may decline or fluctuate as a result of a number of factors, including but not limited to their dissatisfaction with our service, a dissipation or cessation of their need for one or more of our products or services, pricing or competitive product offerings. If we are unable to renew a substantial portion of the contracts that are up for renewal or maintain our pricing, our results of operations and financial condition could be adversely affected. For example, the requirement mandated by CMS for healthcare organizations to transition to the ICD-10 coding system, effective in October 2015, generated significant demand for our ICD-10 readiness training courseware from 2012 through 2015, when subscriptions for that product positively influenced the Company s revenue and operating income. However, sales of that product have ceased and revenue and operating income from that product declined significantly during 2016 and are expected to continue to decline. HealthStream Patient Experience Solutions product and service contracts typically range from one to three years in length, and customers are not obligated to renew their contract with us after their contract expires. If our customers do not renew their arrangements for our services, or if their activity levels decline, our revenue may decline and our business will suffer.

We may be unable to accurately predict the timing of revenue recognition from sales activity as it is often dependent on achieving certain events or performance milestones, and this inability could impact our operating results.

Our ability to recognize revenue is dependent upon several factors including the transfer of customer-specific information such as unique subscriber IDs, which are required for us to implement customers on our subscription-based platform and certain platform applications. Accordingly, if customers do not provide us with the specified information in a timely manner, our ability to recognize revenue will be delayed, which could adversely impact our operating results. In addition, implementation completion and acceptance of our subscription-based platform and certain platform applications by our customers must be achieved and delivery of services is required in connection with subscription-based products for us to recognize revenue. Some products, including those in our Provider Solutions segment, can require significant implementation lead times and the rate at which customer orders move from backlog to revenue generation in connection with these products may significantly affect the timing of revenue recognition. In our Patient Experience business we depend on receiving patient visit, discharge, and other data from our customers before we are able to complete surveys and tabulate responses.

Because we recognize revenue from subscriptions for our products and services over the term of the subscription period, downturns or upturns in sales may not be immediately reflected in our operating results.

During the year ended December 31, 2016, we recognized approximately 71% of our revenue from customers monthly over the terms of their subscription agreements, which have initial contract terms ranging from one to five years. As a result, much of the revenue we report in each quarter is related to subscription agreements entered into during previous quarters. Consequently, a decline in new or renewed subscription agreements in any one quarter will not necessarily be fully reflected in the revenue in that quarter and will negatively affect our revenue in future quarters. In addition, we may be unable to adjust our cost structure to reflect this reduced revenue. Accordingly, the effect of significant downturns in sales and market acceptance of our products and services may not be fully reflected in our results of operations until future periods. Additionally, our subscription model also makes it difficult for us to rapidly increase our revenue through additional sales in any period, as revenue from new customers must be recognized over the applicable subscription term. Finally, the majority of costs associated with our sales cycles are incurred up front before revenue recognition commences, and therefore periods of strong sales performance may increase our costs in the near term negatively affecting our financial performance.

We may not be able to meet our strategic business objectives unless we obtain additional financing, which may not be available to us on favorable terms, or at all.

We believe that our existing cash and cash equivalents, marketable securities, cash generated from operations, and available borrowings under our revolving credit facility will be sufficient to meet anticipated working capital needs, new product development and capital expenditures for at least the next 12 months. However, we may need to raise additional funds in order to:

- develop new, or enhance existing, services or products;
- respond to competitive pressures;
- finance working capital requirements;

acquire or invest in complementary businesses, technologies, content or products; or

otherwise effectively execute our growth strategy.

At December 31, 2016, we had approximately $103.2 million in cash, cash equivalents, and marketable securities. We also have up to

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$50.0 million of availability under our Revolving Credit Facility, subject to certain covenants, which expires in November 2017. We expect to incur between $15.0 and $17.0 million of capital expenditures, software development and content purchases during 2017. We actively review possible business acquisitions to complement or enhance our products and services. We may not have adequate cash and investments or availability under our Revolving Credit Facility to consummate one or more of these acquisitions. We cannot assure you that if we need additional financing that it will be available on terms favorable to us, or at all. If adequate funds are not available or are not available on acceptable terms, our ability to fund expansion, take advantage of available opportunities, develop or enhance services or products or otherwise respond to competitive pressures would be significantly limited. If we raise additional funds by issuing equity or convertible debt securities, the percentage ownership of our existing shareholders may be reduced.

We have significant goodwill and identifiable intangible assets recorded on our balance sheet that may be subject to impairment losses that would reduce our reported assets and earnings.

As of December 31, 2016, our balance sheet included goodwill of $109.8 million and identifiable intangible assets of $78.4 million. There are inherent uncertainties in the estimates, judgments and assumptions used in assessing recoverability of goodwill and intangible assets. Economic, legal, regulatory, competitive, reputational, contractual, and other factors could result in future declines in the operating results of our business units or market value declines that do not support the carrying value of goodwill and identifiable intangible assets. If the value of our goodwill and/or intangible assets is impaired, accounting rules require us to reduce their carrying value and report an impairment charge, which would reduce our reported assets and earnings for the period in which an impairment is recognized.

We may be affected by changes in the healthcare industry that impact our clients.

Our clients are concentrated in the healthcare industry, which is subject to changing regulatory, economic, and political influences. The U.S. Congress and certain state legislatures have passed or are considering laws and regulations intended to result in major changes to the U.S. healthcare system. The most prominent of these reform efforts, the Patient Protection and Affordable Care Act, as amended by the Healthcare and Education Reconciliation Act of 2010 (collectively, Affordable Care Act), was designed to increase access to affordable health insurance for U.S. citizens and improve quality of care, but it also has reduced government program spending and imposed operating costs and changes on many of our clients. Some of these changes have driven consolidation in the healthcare industry, particularly among health insurance providers.

The 2016 federal elections cast uncertainty on the future of the Affordable Care Act and may result in the repeal or replacement of, or significant changes to, the Affordable Care Act. There is uncertainty regarding whether, when, or how the Affordable Care Act will be changed, whether, when or what alternative provisions will be enacted, and the impact of repeal or changes to the Affordable Care Act or any alternative provisions. Any government efforts related to reforming the healthcare industry may negatively impact our clients, which could have an adverse effect on our revenue, results from operations and financial condition.

We may not be able to demonstrate compliance with Sarbanes-Oxley Section 404 in a timely manner, and the correction of any deficiencies identified during annual audits may be costly and could harm our business.

Sarbanes-Oxley Section 404 requires our management to report on, and requires our independent public accounting firm to attest to, the effectiveness of our internal controls over financial reporting. The rules governing the standards to be met are complex and may require significant process review, documentation and testing, as well as remediation efforts for any identified deficiencies. This process of review, documentation, testing and remediation may result in increased expenses and require significant attention from management and other internal and external resources. These requirements may also extend to acquired entities and our efforts to integrate those operations into our system of internal controls. Any material weaknesses identified during this process may preclude us from asserting the effectiveness of our internal controls. This may negatively affect our stock price if we cannot effectively remediate the issues identified in a timely manner.

Changes in generally accepted accounting principles (GAAP) and other accounting regulations and interpretations could require us to delay recognition of revenue and/or incur and accelerate the recognition of expenses, resulting in lower earnings.

While we believe we correctly account for and recognize revenue and expenses, any changes in GAAP or other accounting regulations and interpretations concerning revenue and expense recognition could decrease our revenue or increase our expenses. Changes to regulations concerning revenue recognition could require us to alter our current revenue accounting practices and cause us to either defer revenue into a future period, or to recognize lower revenue in a current period. Likewise, changes to regulations concerning expense recognition could require us to alter our current expense accounting practices and cause us to defer recognition of expense into a future period, or to recognize increased expenses in a current period. Such changes could also cause us to alter the manner in which we contract for, sell, and incentivize sales of products and services. Changes to either revenue recognition or expense recognition accounting practices could affect our financial performance. In addition, we could incur significant during 2017 costs to comply with any changes in GAAP rules or requirements, such as Accounting Standards Update 2014-09, *Revenue from Contracts with Customers (Topic 606),* which is effective January 1, 2018, in addition to the financial impact on accounting for revenues or expenses.

Risks Related to Sales, Marketing and Competition

Our operating margins could be affected if our ongoing refinement to pricing models for our products and services is not accepted by our customers and the market.

We continue to make changes in the pricing of our product and service offerings so as to increase revenue and meet the needs of our customers. We cannot predict whether the current pricing of our products and services, or any ongoing refinements we make will be accepted by our existing customer base or by prospective customers. If our customers and potential customers decide not to accept our current or future pricing or product and service offerings, it could an adverse effect on our business and results of operations.

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Risks Related to Operations

We may be unable to adequately develop our systems, processes and support in a manner that will enable us to meet the demand for our services.

We have provided our online products and services for over 17 years and continue to expand our ability to provide our solutions on both a subscription and transactional basis over the Internet or otherwise. Our future success will depend on our ability to effectively develop and maintain our infrastructure, including procurement of additional hardware and software, and to implement the services, including customer support, necessary to meet the demand for our products and services. Our inability from time to time to successfully develop the necessary systems and implement the necessary services on a timely basis may result in our customers experiencing delays, interruptions and/or errors in their service. Such delays or interruptions may cause customers to become dissatisfied with our service and move to competing providers of workforce development, patient experience, and provider solutions services. If this happens, our reputation results of operations and financial condition, could be adversely affected.

Our business operations could be significantly disrupted if we lose members of, or fail to attract and integrate new members to, our management team.

Our future performance is substantially dependent on the continued services of our management team and our ability to attract, retain and motivate them. The loss of the services of any of our officers or senior managers, or the inability to attract additional officers or senior managers as appropriate, could harm our business, as we may not be able to find suitable replacements. We do not have employment agreements with any of our key personnel, other than our chief executive officer, and we do not maintain any key person life insurance policies.

We may not be able to attract, hire and retain a sufficient number of qualified employees and, as a result, we may not be able to effectively execute our growth strategy or maintain the quality of our services.

Our future success will depend on our ability to attract, train, motivate, and retain other highly skilled technical, managerial, marketing, customer support, coaching, and survey personnel. Competition for certain personnel is intense, especially for software developers, web designers, user experience and interaction designers, and sales personnel, and we may be unable to successfully attract sufficiently qualified personnel. We have experienced in the past, and continue to experience, difficulty hiring qualified personnel in a timely manner for these positions. The pool of qualified technical personnel, in particular, is limited in Nashville, Tennessee, where our headquarters are located. In addition, we operate interviewing centers located in Laurel, Maryland, and Nashville, Tennessee. We may experience difficulty in maintaining and recruiting qualified individuals to perform interviewing services. We will also need to maintain or increase the size of our staff to support our anticipated growth, without compromising the quality of our offerings or customer service. Our inability to locate, attract, hire, integrate and retain qualified personnel in sufficient numbers may reduce the quality of our services and impair our ability to grow.

We may not be able to upgrade our hardware and software technology infrastructure quickly enough to effectively meet demand for our services or our operational needs.

We must continue to obtain reasonably priced, commercially available hardware and operating software as well as continue to enhance our software and systems to accommodate the increased use of our platform, the increased courseware and content in our library, the expanding amount and type of data we store on behalf of our customers, and the resulting increase in operational demands on our business. Decisions about hardware and software enhancements are based in part on estimated forecasts of the growth in demand for our services. This growth in demand for our services is difficult to forecast and the potential audience for our services is widespread and dynamic. If we are unable to increase the data storage and processing capacity of our systems at least as fast as the growth in demand, our customers may encounter delays or disruptions in their service. Unscheduled downtime, or reduced response time of our platforms could harm our business and also could discourage current and potential customers from using or continuing to use our services and reduce future revenue. If we are unable to acquire, update, or enhance our technology infrastructure and systems quickly enough to effectively meet increased operational demands on our business, that may also have an adverse effect on our results of operations or financial condition. Further, as we develop our platforms and rely on every changing and improving technologies, we may be impeded by our customers inability to adopt new technologies, such as web browsers, upon which new platform enhancements may be based.

Our network infrastructure and computer systems and software may fail.

An unexpected event (including but not limited to a cyber-security incident, telecommunications failure, fire, earthquake, or other catastrophic loss) at our Internet service providers facilities or at our on-site data center facilities could cause the loss of critical data and prevent us from offering our products and services for an unknown period of time. System downtime could negatively affect our reputation and ability to sell our products and services and may expose us to significant third-party claims. Our cyber liability and business interruption insurance may not adequately compensate us for losses that may occur. In addition, we rely on third parties to

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securely store our archived data, house our web server and network systems and connect us to the Internet. While our service providers have planned for certain contingencies, the failure by any of these third parties to provide these services satisfactorily and our inability to find suitable replacements would impair our ability to access archives and operate our systems and software, and our customers may encounter delays. Such disruptions could harm our reputation and cause customers to become dissatisfied and possibly take their business to a competing provider, which would adversely affect our revenues.

We may lose users and lose revenue if our security measures fail.

If the security measures that we use to protect customer or personal information are ineffective, we may lose users of our services, which could reduce our revenue, tarnish our reputation, and subject us to significant liability. We rely on security and authentication technology licensed from third parties. With this technology, we perform real-time credit card authorization and verification, as well as the encryption of other selected secure customer data. We cannot predict whether these security measures could be circumvented by new technological developments. Further, the audit processes and controls used within our production platforms may not be sufficient to identify and prevent errors or deliberate misuse. In addition, our software, databases and servers may be vulnerable to computer viruses, physical or electronic attacks and similar disruptions. We may need to spend significant resources to protect against security breaches or to alleviate problems caused by any breaches. We cannot assure that we can prevent all security breaches.

A data breach or security incident could result in a loss of confidential data, give rise to remediation and other expenses, expose us to liability under the Health Insurance Portability and Accountability Act (HIPAA), the Health Information Technology for Economic and Clinical Health Act (HITECH), state privacy laws, consumer protection laws, common law theories or other laws, subject us to litigation and federal and state governmental inquiries, damage our reputation, and otherwise be disruptive to our business.

We collect and store sensitive information, including intellectual property individually identifiable health information, provider credentialing and privileging data, and other personally identifiable information, on our networks. The secure maintenance of this information is critical to our business operations. As a result, the continued development and enhancement of controls processes and practices designed to protect our information systems from attack, damage or unauthorized access remain a priority for us. We have implemented multiple layers of security measures to protect confidential data through technology, processes, and our people and our defenses are monitored and routinely tested internally and by external parties. Despite these efforts, a data breach or security incident could result from a variety of circumstances and events, including third-party action, system errors, employee negligence or error, malfeasance, computer viruses, failures during the process of upgrading or replacing software, databases, or components thereof, power outages, hardware failures, telecommunication failures, user errors, catastrophic events, or threats from malicious persons and groups, new vulnerabilities, and advanced new attacks against information systems.

There can be no assurance, we will not be subject to data incidents that bypass our security measures, result in loss of confidential information or disrupt our information systems or business. Data incidents could result in interruptions, delays, the loss, access misappropriation, and disclosure or corruption of data and could damage our reputation. In addition, data incidents could expose us and our customers to liability under privacy, security and consumer protection laws, such as HIPAA, or litigation under these or other laws, including common law theories, and subject us to federal and state governmental inquiries or enforcement, especially if a large number of individuals are affected or if the compromised information is highly sensitive. Like many other organizations, we have experienced data incidents from time to time in the course of our business and handled these incidents in accordance with our understanding of the applicable laws.

As a result, cyber security and us. As cyber and other threats to confidential information continue to evolve, we may be required to expend significant additional resources to continue to modify or enhance our protective measures or to investigate and remediate any security vulnerabilities. The occurrence of a data incident and resulting potential costs and liabilities could have a material adverse effect on our financial position and results of operations and harm our business reputation.

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We may experience errors or omissions in our software products or processes, including those that deliver provider credentialing, privileging and payer enrollment services for our hospitals and medical practice customers, and those that and administer and report on hospital performance, and these errors could result in action taken against us that could harm our business.

Hospitals and medical practices use our credentialing, privileging, and payer enrollment software to manage, validate and maintain their providers credentials and authorization to practice in a particular facility, and to maintain authorization to perform care covered by insurance providers. In some instances, we rely on sources outside the Company for information that we use in our credentialing and privileging products. If errors or omissions occur that inaccurately validate or invalidate the credentials of a provider, or improperly deny or authorize a provider to practice in a hospital or medical practice, these errors or omissions could result in litigation brought against us either by our customers, the provider, or other interested parties. For example, an important element in a malpractice case brought against a hospital or other provider could be the validation of proper credentialing for the provider, and any errors or omissions in our products that provide these services could subject us to claims. Further, a list of providers privileges may be made available to the general public by hospitals and medical practices, and errors in credentialing and privileging may result in damage to the hospital, medical practice, or provider.

Certain survey data collected and reported by us, such as the survey data included as part of our CAHPS® Hospital survey is used by CMS to determine, in part, the amount of reimbursement payments to hospitals, and any errors in data collection, survey sampling, or statistical reporting could result in reduced reimbursements to our hospital customers if we are unable to correct these errors, and this could, in turn, result in litigation or claims against us. Further, this survey data reported to CMS is then published by CMS to the general public, and any errors we experience that result in incorrect scoring of our hospital customer may result in damage to that hospital s reputation, and the hospital may in turn bring litigation against us.

We may be required to indemnify against such claims, and defending against any such claims could be costly and time consuming and could negatively affect our business.

Risks Related to Government Regulation, Content and Intellectual Property

Government regulation may subject us to investigation, litigation, or liability or require us to change the way we do business.

The laws and regulations that govern our business change rapidly. Evolving areas of law that are relevant to our business include privacy and security laws, proposed encryption laws, content regulation, information security accountability regulation, sales and use tax laws and regulations and attempts to regulate activities on the Internet. For example, we are directly subject to certain requirements of the HIPAA privacy and security regulations. In addition, we are required through contracts with our customers known as business associate agreements to protect the privacy and security of certain personal and health related information. Further government laws and regulations such as the Affordable Care Act, that directly affect our customers, can have an indirect impact on our business.

The rapidly evolving and uncertain regulatory and technology environment could require us to change how we do business or incur additional costs. It may be difficult to predict how changes to these laws and regulations might affect our business. Our current and past privacy and security practices, including any breaches of protected health information or other data, could be subject to review or other investigation by various state and federal regulatory authorities or could become the subject of future litigation.

Failure to comply with applicable laws and regulations, including those governing privacy and security, could subject us to civil and criminal penalties, subject us to contractual penalties (including termination of our customer agreements), adversely affect our ability to retain clients and attract new clients, damage our reputation or otherwise have a detrimental impact on our business.

We may not be able to maintain our certification to conduct CMS mandated surveys, and this could adversely affect our business.

Our survey product offerings include providing survey services to assist customers in their compliance with CMS regulations. We are currently designated by CMS as a certified vendor to offer CAHPS® Hospital Surveys and CAHPS® data collection and submission services for hospitals, home health agencies, clinicians and groups, in-center hemodialysis, emergency departments, hospice, outpatient surgery, pediatrics, and accountable care organizations. If we are unable to maintain these certifications, or secure certifications for future CMS mandated surveys, we would not be able to administer these survey instruments for our customers and our business may suffer.

Any reduction or change in the regulation of continuing education and training in the healthcare industry may adversely affect our business.

A portion of our business model is dependent in part on required training and continuing education for healthcare professionals and other healthcare workers resulting from regulations of state and federal agencies, state licensing boards and professional organizations. Any change in these regulations that reduce the requirements for continuing education and training for the healthcare industry could harm our business. In addition, a portion of our business with pharmaceutical and medical device manufacturers and hospitals is predicated on our ability to maintain accreditation status with organizations such as the ACCME, ANCC, and ACPE. The failure to maintain status as an accredited provider could have a detrimental effect on our business.

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We may be liable to third parties for the content in our online library if the text, graphics, software or other content in our library violates copyright, trademark, or other intellectual property rights, if our content partners violate their contractual obligations to others by providing content to our library, or if the content does not conform to accepted standards of care in the healthcare profession. Further, we may be liable to these content partners if we improperly release and lose control of their content stored on our platform either due to security issues or through improper release to customers who have not paid for access to this content. We attempt to minimize these types of liabilities by requiring representations and warranties relating to our content partners ownership of the rights to distribute as well as the accuracy of their content. We also take necessary measures to review this content ourselves. Although our agreements with our content partners in most instances contain provisions providing for indemnification by the content providers in the event of inaccurate content, our content partners may not have the financial resources to meet this obligation. Alleged liability could harm our business by damaging our reputation, requiring us to incur legal costs in defense, exposing us to awards of damages and costs, and diverting management s attention away from our business.

Protection of certain intellectual property may be difficult and costly, and our inability to protect our intellectual property could reduce the value of our products and services.

Despite our efforts to protect our intellectual property rights, a third party could, without authorization, copy or otherwise misappropriate our content, information from our databases, or other intellectual property. Our agreements with employees, consultants and others who participate in development activities could be breached and result in our trade secrets becoming known, or our trade secrets and other intellectual property could be independently developed by competitors. We may not have adequate remedies for such breaches or protections against such competitor developments. In addition, the laws of some foreign countries do not protect our proprietary rights to the same extent as the laws of the United States, and effective intellectual property protection may not be available in those jurisdictions. We currently own several applications and registrations for trademarks and domain names in the United States and other countries as well as certain common law trademarks and service marks. The current system for registering, allocating and managing domain names has been the subject of litigation and proposed regulatory reform. Additionally, legislative proposals have been made by the federal government that would afford broad protection to owners of databases of information, such as stock quotes. This protection of databases already exists in the European Union.

Our business could be harmed if unauthorized parties infringe upon or misappropriate our intellectual property, proprietary systems, content, platform, services or other information. Our efforts to protect our intellectual property through copyright, trademarks and other controls may not be adequate. For instance, we may not be able to secure trademark or service mark registrations for marks in the United States or in foreign countries, or to secure patents for our proprietary products and services, and even if we are successful in obtaining patent and/or trademark registrations, these registrations may be opposed or invalidated by a third party.

There has been substantial litigation in the computer and online industries regarding intellectual property assets, particularly patents. Third parties may claim infringement by us with respect to current and future products, trademarks or other proprietary rights, and we may counterclaim against such third parties in such actions. Any such claims or counterclaims could be time-consuming, result in costly litigation, divert management s attention, cause product release delays, require us to redesign our products, restrict our use of the intellectual property subject to such claim, or require us to enter into royalty or licensing agreements, any of which could have an adverse effect upon our business, financial condition and operating results. Such royalty and licensing agreements may not be available on terms acceptable to us, if at all.

We may be liable for infringing the intellectual property rights of others.

Our competitors may develop similar intellectual property, duplicate our products and/or services, or design around any patents or other intellectual property rights we hold. In the future, litigation may be necessary to enforce our intellectual property rights or to determine the validity and scope of the patents, intellectual property or other proprietary rights of third parties, which could be time consuming and costly and have an adverse effect on our business and financial condition. Intellectual property infringement claims could be made against us, especially as the number of our competitors grows. These claims, even if not meritorious, could be expensive and divert our attention from operating our company and result in a temporary inability to use the intellectual property subject to such claim. In addition, if we and/or our affiliates and customers become liable to third parties for infringing their intellectual property rights, we could be required to pay a substantial damage award and develop comparable non-infringing intellectual property, to obtain a license, or to cease providing the content or services that contain the infringing intellectual property. We may be unable to develop non-infringing intellectual property or obtain a license on commercially reasonable terms, if at all.

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Item 1B. ***Unresolved Staff Comments***

None.

Item 2. ***Properties***

Our principal office is located in Nashville, Tennessee, which is primarily used to support our workforce solutions operations and corporate functions. Our lease for approximately 73,000 square feet at this location expires in April 2019. We also lease other facilities in Laurel, Maryland; Nashville, Tennessee; Jericho, New York; Brentwood, Tennessee; San Diego, California; Chicago, Illinois; Boulder, Colorado; and Pensacola, Florida. The facilities in Laurel, Maryland and Nashville, Tennessee are used to support our survey operations, while the other leased locations are principally satellite offices.

Item 3. ***Legal Proceedings***

None.

Item 4. ***Mine Safety Disclosures***

Not applicable.

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PART II

Item 5. ***Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities***

Our common stock is traded on the NASDAQ Global Select Market under the symbol HSTM . Our common stock began trading on the NASDAQ National Market on April 14, 2000.

The following table sets forth, for each quarter of the two most recent years, the high and low closing prices per share of our common stock as reported on the NASDAQ Global Select Market:

	Common Stock Price			
	2016		2015	
	High	Low	High	Low
First Quarter	$ 22.35	$ 18.20	$ 30.36	$ 24.63
Second Quarter	26.58	21.17	31.91	25.15
Third Quarter	27.65	23.73	32.14	21.60
Fourth Quarter	28.39	22.06	25.63	21.31

As of February 13, 2017, the Company had a total of 9,547 shareholders, including 593 registered holders and 8,954 beneficial holders.

SHARE REPURCHASE PROGRAM

In February 2016, our Board of Directors authorized a share repurchase program for up to $25 million of our outstanding common stock. The share repurchase program terminated on December 31, 2016 and no share repurchases were made under the program.

DIVIDEND POLICY

We have never declared or paid any cash dividends on our common stock, and we do not anticipate paying cash dividends in the foreseeable future. We intend to retain earnings for use in the operation of our business.

See the table labeled Securities Authorized for Issuance Under Equity Compensation Plans to be contained in our 2017 Proxy Statement, incorporated by reference in Part III, Item 12 of this Annual Report on Form 10-K.

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STOCK PERFORMANCE GRAPH

The graph below compares HealthStream, Inc. s cumulative total shareholder return on common stock with the cumulative total returns of companies on the NASDAQ Composite Index and the NASDAQ Computer & Data Processing Index for each of the last five fiscal years ended December 31, 2016, assuming an initial investment of $100. Data for the NASDAQ Composite Index and the NASDAQ Computer & Data Processing Index assume the reinvestment of dividends.

The comparisons in the graph below are based on historical data and are not necessarily indicative of future performance of our common stock.

COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN [(1)]

Among HealthStream, Inc., The NASDAQ Composite Index

And The NASDAQ Computer & Data Processing Index

(1) $100 invested on 12/31/11 in stock or index, including reinvestment of dividends. Fiscal year ending December 31.

RECENT SALES OF UNREGISTERED SECURITIES

None.

ISSUER PURCHASES OF EQUITY SECURITIES

None.

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Item 6. ***Selected Financial Data***

The selected statement of income and balance sheet data for the past five years are derived from our audited consolidated financial statements. You should read the following selected financial data in conjunction with our consolidated financial statements and the notes to those statements and Management s Discussion and Analysis of Financial Condition and Results of Operations located elsewhere in this report.

HealthStream acquired Decision Critical, Inc. on June 29, 2012, Sy.Med Development, Inc. on October 19, 2012, substantially all of the assets of BLG on September 9, 2013, HCCS on March 3, 2014, HLS on March 16, 2015, Performance Management Services, Inc. on June 30, 2016, acquired the remaining ownership interest in Nursing Registry Consultants Corporation on July 25, 2016, and MAI on August 8, 2016. The results of operations for these acquired companies are included within our consolidated statement of income data effective from the respective date of acquisition. Revenues may be subject to fluctuations as discussed further in Management s Discussion and Analysis of Financial Condition and Results of Operations located elsewhere in this report. As a result of these factors, the annual results presented below are not comparable. The operating results for any single year are not necessarily indicative of the results to be expected in the future.

	Year Ended December 31, (in thousands, except per share data)				
	2016	**2015**	**2014**	**2013**	**2012**
STATEMENT OF INCOME DATA:					
Revenues, net	$ 225,974	$ 209,002	$ 170,690	$ 132,274	$ 103,732
Total operating costs and expenses	220,407	195,445	154,315	117,608	90,273
Operating income	5,567	13,557	16,375	14,666	13,459
Net income	$ 3,755	$ 8,621	$ 10,394	$ 8,418	$ 7,645
Net income per share basic	$ 0.12	$ 0.29	$ 0.38	$ 0.31	$ 0.29
Net income per share diluted	$ 0.12	$ 0.28	$ 0.37	$ 0.30	$ 0.28
Weighted average shares of common stock outstanding basic	31,721	30,057	27,570	26,853	26,128
Weighted average shares of common stock outstanding diluted	32,068	30,436	28,023	27,663	27,507
BALANCE SHEET DATA:					
Cash and cash equivalents	$ 49,634	$ 82,010	$ 81,995	$ 59,537	$ 41,365
Marketable securities	53,540	66,976	38,973	48,659	51,952
Accounts receivable, net	44,805	36,348	33,167	25,314	15,348
Goodwill and intangible assets	188,129	139,039	56,709	44,616	38,104
Working capital	82,467	120,459	97,352	90,912	83,259
Total assets	396,000	379,569	257,262	212,594	174,528
Deferred revenue current and noncurrent	76,401	69,448	57,373	38,168	23,146
Shareholders equity	286,108	280,320	167,859	149,433	132,196

Item 7. ***Management s Discussion and Analysis of Financial Condition and Results of Operations***

The following discussion of the financial condition and results of operations of HealthStream should be read in conjunction with Selected Financial Data and HealthStream s Consolidated Financial Statements and related notes thereto included elsewhere in this report. This discussion contains forward-looking statements that involve risks and uncertainties. HealthStream s actual results may differ significantly from the results discussed and those anticipated in these forward-looking statements as a result of many factors, including but not limited to those described under Risk Factors and elsewhere in this report.

OVERVIEW

HealthStream provides workforce development, patient experience, and provider solutions for healthcare organizations all designed to assess and develop the people that deliver patient care which, in turn, supports the improvement of business and clinical outcomes. Workforce Solutions products are used by healthcare organizations to meet a broad range of their training, certification, competency assessment, performance appraisal, and development needs. Patient Experience Solutions products provide our customers information about patients experiences and how to improve them, workforce engagement, physician relations, and community perceptions of their services. Provider Solutions products are used by healthcare organizations for provider credentialing, privileging, call center and enrollment needs. HealthStream s customers include healthcare organizations, pharmaceutical and medical device companies, and other participants in the healthcare industry.

Revenues for the year ended December 31, 2016 were approximately $226.0 million compared to $209.0 million for the year ended December 31, 2015, an increase of 8%. Operating income decreased by 59% to $5.6 million for 2016, compared to $13.6 million for 2015. Net income decreased by 56% to $3.8 million for 2016, compared to $8.6 million for 2015. Earnings per share (EPS) were $0.12 per share (diluted) for 2016 compared to $0.28 per share (diluted) for 2015. Revenues from HealthStream Workforce Solutions grew by 4%, or $6.7 million; revenues from HealthStream Patient Experience Solutions declined by 1%, or $0.3 million; and revenues from HealthStream Provider Solutions grew by 78%, or $10.6 million. As of December 31, 2016, the Company had approximately 4.55 million total subscribers, of which approximately 4.47 million were fully implemented subscribers on its SaaS-based platform. Annualized revenue per implemented subscriber increased to $37.28 per subscriber at the end of 2016, up from $36.96 per subscriber at the end of 2015, representing a 1% increase. As of December 31, 2016 cash and investment balances approximated $103.2 million, and the Company maintained full availability under its $50.0 million revolving credit facility.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Revenue Recognition

Revenues are recognized from subscription-based workforce development products and courseware subscriptions based on a per person subscription basis, and in some cases on a per license basis. Fees are based on the size of the facilities or organizations employee user population and the service offerings to which they subscribe. Subscription-based revenue is recognized ratably over the service period of the underlying contract. All other service revenues are recognized as the related services are performed or products are delivered.

Revenues from provider solutions products are predominantly related to software licensing and support/maintenance renewals. Revenues derived from the license of installed software products are recognized using the residual method upon delivery of the software when vendor specific objective evidence (VSOE) of fair value for the undelivered elements within the contract can be established. For installed software products, if the Company cannot objectively determine the fair value of each undelivered element based on the VSOE of fair value, the Company defers revenue recognition until all elements are delivered, all services have been performed, or until fair value can be objectively determined. Software support and maintenance revenues are recognized ratably over the term of the related agreement.

Revenues from patient experience services are recognized when survey results are delivered to customers via either Internet-based reporting throughout the survey period or by providing final survey results once all services are complete. A significant portion of revenues for survey and reporting services that are provided through the use of Internet-based reporting methodologies are recognized using the proportional performance method, reflecting recognition throughout the service period which corresponds with the survey cycle and reporting access by the customer, which typically ranges from one to five months. If survey results are delivered to the customer after all services have been completed, then the corresponding revenues are recognized in full in the period such results are provided to the customer. Coaching and consulting revenues are generally recognized using the proportional performance method as these services are performed throughout the contract term. All other revenues are recognized as the related services are performed or products are delivered to the customer. Revenues for these services can be subject to seasonal factors based on customers requirements that can impact the timing, frequency, and volume of survey cycles.

Revenues from professional services primarily include consulting and courseware development services. Fees are based on the time and efforts involved, and revenue is recognized upon completion of performance milestones using the proportional performance method.

The Company offers training services for clients to facilitate integration of its software solutions. Fees for training are based on the time and efforts of the personnel involved. Basic online training is generally included in the initial contract; however, incremental training is fee based and revenues are generally recognized upon completion of training services.

Accounting for Income Taxes

The Company accounts for income taxes using the asset and liability method, whereby deferred tax assets and liabilities are determined based on the temporary differences between the financial statement and tax bases of assets and liabilities measured at tax rates that will be in effect for the year in which the differences are expected to affect taxable income. Management periodically assesses the realizability of its deferred tax assets, and to the extent that we believe a recovery is not likely, we establish a valuation allowance to reduce the deferred tax asset to the amount we estimate will be recoverable. The Company maintains a valuation allowance of approximately $654,000 for the portion of its deferred tax assets that are not more likely than not expected to be realized.

Software Development Costs

Capitalized software development includes costs to develop and maintain our products and applications, including our SaaS-based workforce development platform products and our survey reporting applications, which are accounted for as internal use software. For internal use software development, once planning is completed and the software development process begins, internal costs and payments to third parties associated with the software development efforts are capitalized when the life expectancy is greater than one year and the anticipated cash flows are expected to exceed the cost of the related asset. During 2016 and 2015, we capitalized approximately $10.0 million and $7.3 million, respectively, for software development. Such amounts are included in the accompanying consolidated balance sheets under the caption capitalized software development. The Company amortizes capitalized software development costs over their expected life, which is generally three to five years. Capitalized software development costs are subject to a periodic impairment review in accordance with our impairment review policy. In connection with capitalized software development, significant estimates involve the assessment of the development period for new products and feature enhancements, as well as the expected useful life of underlying software, feature enhancements, or product created. Once capitalized, software development costs are subject to the policies and estimates described below regarding goodwill, intangibles and other long-lived assets.

Goodwill, Intangibles and Other Long-lived Assets

The Company evaluates goodwill for impairment at the reporting unit level by assessing whether it is more likely than not that the fair value of a reporting unit exceeds its carrying value. If this assessment concludes that is more likely than not that the fair value of a reporting unit exceeds its carrying value, then goodwill is not considered impaired and no further impairment testing is required. Conversely, if the assessment concludes that it is more likely than not that the fair value of a reporting unit is less than its carrying value, a goodwill impairment test is performed to compare the fair value of the reporting unit to its carrying value. The Company determines fair value of the reporting units using both income and market based models. Our models contain significant assumptions and accounting estimates about discount rates, future cash flows and terminal values that could materially affect our operating results or financial position if they were to change significantly in the future and could result in an impairment. We perform our goodwill impairment assessment whenever events or changes in facts or circumstances indicate that impairment may exist and also during the fourth quarter each year. Intangible assets and other long-lived assets are also reviewed for events or changes in facts and circumstances, both internally and externally, which may indicate an impairment is present. We measure any impairment using observable market values or discounted future cash flows from the related long-lived assets. The cash flow estimates and discount rates incorporate management s best estimates, using appropriate and customary assumptions and projections at the date of evaluation.

Allowance for Doubtful Accounts

The Company estimates the allowance for doubtful accounts using both a specific and non-specific identification method. Management s evaluation includes reviewing past due accounts on a case-by-case basis, and determining whether an account should be reserved, based on the facts and circumstances surrounding each potentially uncollectible account. An allowance is also maintained for accounts not specifically identified that may become uncollectible in the future. Uncollectible accounts are written-off in the period management believes it has exhausted every opportunity to collect payment from the customer. Bad debt expense is recorded when events or circumstances indicate an additional allowance is necessary based on our specific and non-specific identification approach. Our allowance for doubtful accounts totaled approximately $863,000 as of December 31, 2016.

Stock Based Compensation

The Company recognizes compensation expense using a fair-value based method for costs related to share based payments including stock options and restricted share units. Measurement of such compensation expense requires significant estimation and assumptions; however, we believe that the Black Scholes option pricing model used for calculating the fair value of our stock based compensation plans provides a reasonable measurement methodology using a framework that is widely adopted.

As of December 31, 2016, the Company had three stock incentive plans under which awards were outstanding, which qualified as stock based compensation plans. During the years ended December 31, 2016, 2015, and 2014, approximately $2.0 million, $3.3 million, and $1.6 million of stock based compensation expense was recorded, respectively. The Company has historically granted equity based awards to both its management group and members of the Company s board of directors on an annual basis under stockholder-approved plans, and expects to continue providing equity awards to these groups for the foreseeable future. The Company also provides grants of equity based awards when new members of the management group begin their employment, or when new members join the Company s board of directors. As of December 31, 2016, total future compensation cost related to non-vested awards not yet recognized was approximately $3.1 million net of estimated forfeitures, with a weighted average expense recognition period of 2.4 years. Future compensation expense recognition for new equity based award grants will vary depending on the timing and size of new awards granted, changes in the market price or volatility of our common stock, changes in risk-free interest rates, or if actual forfeitures vary significantly from initial estimates.

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RESULTS OF OPERATIONS

Revenues and Expense Components

The following descriptions of the components of revenues and expenses apply to the comparison of results of operations.

Revenues, net. Revenues for our HealthStream Workforce Solutions business segment primarily consist of the following products and services: provision of services through our SaaS-based platform, authoring tools, a variety of courseware subscriptions, competency and performance appraisal tools, implementation and consulting services, content development, online sales training courses (RepDirect), HospitalDirect®, SimVentures, and a variety of other educational activities to serve professionals that work within healthcare organizations. Revenues for our HealthStream Patient Experience Solutions business segment consist of quality and satisfaction surveys, data analyses of survey results, coaching/consulting services, and other research-based measurement tools focused on patients, employees, physicians, and other members of the community. Revenues for our HealthStream Provider Solutions business segment consist of proprietary software applications to help facilitate provider credentialing, privileging, call center and enrollment administration for healthcare organizations.

Cost of Revenues (excluding depreciation and amortization). Cost of revenues (excluding depreciation and amortization) consists primarily of salaries and employee benefits, stock based compensation, employee travel and lodging, materials, outsourced phone survey support, contract labor, hosting costs, and other direct expenses associated with revenues, as well as royalties paid by us to content providers based on a percentage of revenues. Personnel costs within cost of revenues are associated with individuals that facilitate product delivery, provide services, conduct, process and manage customer surveys, handle customer support calls or inquiries, manage the technology infrastructure for our hosted applications, manage content and survey services, coordinate content maintenance services, and provide training or implementation services.

Product Development. Product development consists primarily of salaries and employee benefits, contract labor, stock based compensation, costs associated with the development of new software feature enhancements, new products, and costs associated with maintaining and developing our platform products. Personnel costs within product development include our systems, application development, and quality assurance teams, product managers, and other personnel associated with software and product development.

Sales and Marketing. Sales and marketing consists primarily of salaries, commissions and employee benefits, stock based compensation, employee travel and lodging, advertising, trade shows, promotions, and related marketing costs. We have historically hosted a national customer conference in Nashville, Tennessee known as Summit, a significant portion of the costs of which are included in sales and marketing expenses. Personnel costs within sales and marketing include our sales teams and marketing personnel.

Other General and Administrative Expenses. Other general and administrative expenses consist primarily of salaries and employee benefits, stock based compensation, employee travel and lodging, facility costs, office expenses, fees for professional services, business development and acquisition related costs, and other operational expenses. Personnel costs within general and administrative expenses include individuals associated with normal corporate functions (accounting, legal, business development, human resources, administrative, internal information systems, and executive management).

Depreciation and Amortization. Depreciation and amortization consist of fixed asset depreciation, amortization of intangibles considered to have definite lives, and amortization of capitalized software development.

Other Income (Expense), Net. The primary component of other income is interest income related to interest earned on cash, cash equivalents and investments in marketable securities. The primary component of other expense is interest expense related to our revolving credit facility. In addition, the income or loss attributed to equity method investments is included in this category.

2016 Compared to 2015

Revenues, net. Revenues increased approximately $16.9 million, or 8%, to $225.9 million for 2016 from $209.0 million for 2015. A comparison of revenues by business segment is as follows (in thousands):

Revenues by Business Segment:	**2016**	**2015**	**Percentage Change**
Workforce	$ 168,040	$ 161,293	4%
Patient Experience	33,850	34,189	(1)%
Provider	24,084	13,520	78%
Total revenues, net	$ 225,974	$ 209,002	8%
% of Revenues			
Workforce	74%	77%	
Patient Experience	15%	16%	
Provider	11%	7%	

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Revenues for HealthStream Workforce Solutions, which are primarily subscription-based, increased approximately $6.7 million, or 4%, over 2015. Revenues in 2016 were positively influenced by growth in courseware subscriptions and our enterprise applications, but were partially offset by an expected decline in ICD-10 readiness revenues. Revenues from ICD-10 readiness products declined by $18.2 million to $8.5 million in 2016 compared to $26.7 million in 2015. The requirement mandated by CMS for healthcare organizations to transition to the ICD-10 coding system was effective in October 2015, and generated significant demand for our ICD-10 readiness training courseware from 2012 through 2015. However, as a result of the effectiveness of such mandate in October 2015, sales of that product have ceased and there will not be renewals of the specific ICD-10 readiness product. Our Workforce Solutions annualized revenue per implemented subscriber increased by 1%, to $37.28 per subscriber at the end of 2016 compared to $36.96 per subscriber at the end of 2015. Implemented subscribers decreased by less than 1% during 2016 to 4.47 million subscribers at the end of 2016 compared to 4.48 million subscribers at the end of 2015. Additionally, total subscribers decreased by less than 2%, with 4.55 million total subscribers at December 31, 2016 compared to 4.62 million total subscribers at December 31, 2015.

Revenues for HealthStream Patient Experience Solutions decreased approximately $343,000, or 1%, compared to 2015. Revenues from Patient Insights surveys, our survey research product that generates recurring revenues, decreased by $239,000, or 1% compared to 2015. The decline in our patient survey revenues is partially due to changes in product mix, such as the adoption of our e-survey products, which have both lower revenue and cost per survey than our traditional phone survey products. Revenues from other products, including surveys conducted on annual or bi-annual cycles and consulting/coaching services, collectively decreased by $101,000, or 1%, compared to 2015.

Revenues for HealthStream Provider Solutions increased approximately $10.6 million, or 78%, over 2015. Revenues from both the HLS and MAI acquisitions, which were consummated in March 2015 and August 2016, respectively, accounted for the majority of the increase in revenues during 2016. Revenues from the MAI acquisition, which was consummated on August 8, 2016, were approximately $2.6 million during 2016.

Cost of Revenues (excluding depreciation and amortization). Cost of revenues increased approximately $7.2 million, or 8%, to $96.6 million for 2016 from $89.4 million for 2015. Cost of revenues as a percentage of revenues was approximately 43% of revenues for both 2016 and 2015. Cost of revenues for HealthStream Workforce Solutions increased approximately $3.8 million to $67.4 million and approximated 40% and 39% of revenues for HealthStream Workforce Solutions for 2016 and 2015, respectively. The increase in both amount and as a percentage of revenues is primarily associated with increased royalties paid by us resulting from growth in courseware subscription revenues, increased personnel costs, and other support costs. The increase was partially offset by a decrease in stock based compensation. Cost of revenues for HealthStream Patient Experience Solutions decreased approximately $697,000 to $21.7 million and approximated 64% and 65% of revenues for HealthStream Patient Experience Solutions for 2016 and 2015, respectively. The decrease in amount is primarily associated with lower personnel costs and stock based compensation. Cost of revenues for HealthStream Provider Solutions increased approximately $4.1 million to $7.6 million and approximated 32% and 26% of HealthStream Provider Solutions revenues for 2016 and 2015, respectively. The increase in amount and as a percentage of revenues is primarily the result of increased personnel and related costs, including additional personnel from MAI.

Product Development. Product development expenses increased approximately $4.7 million, or 19%, to $28.9 million for 2016 from $24.2 million for 2015. Product development expenses as a percentage of revenues were approximately 13% and 12% of revenues for 2016 and 2015, respectively.

Product development expenses for HealthStream Workforce Solutions increased approximately $1.0 million and approximated 12% of revenues for HealthStream Workforce Solutions for both 2016 and 2015. The increase in amount is due to additional personnel expenses associated with new product development initiatives for our subscription-based products. This increase was partially offset by lower stock based compensation. Product development expenses for HealthStream Patient Experience Solutions increased approximately $2.3 million and approximated 14% and 7% of revenues for HealthStream Patient Experience Solutions for 2016 and 2015, respectively. The increase in both amount and as a percentage of revenue is due to additional personnel expenses associated with new product development initiatives. Product development expenses for HealthStream Provider Solutions increased approximately $1.3 million and approximated 16% and 18% of revenues for HealthStream Provider Solutions for 2016 and 2015, respectively. The increase in amount is primarily the result of increased personnel costs, including additional personnel from MAI.

Sales and Marketing. Sales and marketing expenses, including personnel costs, increased approximately $3.4 million, or 10%, to $39.0 million for 2016 from $35.6 million for 2015. Sales and marketing expenses were approximately 17% of revenues for both 2016 and 2015.

Sales and marketing expenses for HealthStream Workforce Solutions increased approximately $1.6 million and approximated 17% of revenues for HealthStream Workforce Solutions for both 2016 and 2015. The increase in amount is mainly due to additional personnel, sales commissions, and increased marketing spending. Sales and marketing expenses for HealthStream Patient Experience Solutions decreased approximately $446,000, and approximated 12% and 13% of revenues for HealthStream Patient Experience Solutions for 2016 and 2015, respectively. The decrease in both amount and as a percentage of revenues is primarily due to reduced marketing personnel and related costs. Sales and marketing expenses for HealthStream Provider Solutions increased approximately $1.7 million, and approximated 22% and 26% of revenues for HealthStream Provider Solutions for 2016 and 2015, respectively. The increase in amount is primarily the result of increased personnel costs, sales commissions, and marketing spending. The unallocated corporate portion of sales and marketing expenses increased by $584,000 primarily due to additional marketing personnel and related costs.

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Other General and Administrative Expenses. Other general and administrative expenses increased approximately $4.4 million, or 15%, to $33.7 million for 2016 from $29.3 million for 2015. Other general and administrative expenses as a percentage of revenues were approximately 15% and 14% of revenues for 2016 and 2015, respectively.

Other general and administrative expenses for HealthStream Workforce Solutions increased approximately $1.4 million over 2015 primarily associated with increased technology infrastructure investments. Other general and administrative expenses for HealthStream Patient Experience Solutions increased approximately $443,000 over 2015 due to additional personnel and facility costs. Other general and administrative expenses for HealthStream Provider Solutions increased approximately $1.3 million over 2015 primarily associated with increased personnel expenses and facility costs, including costs associated with the MAI acquisition. The unallocated corporate portion of other general and administrative expenses increased approximately $1.3 million over 2015, primarily associated with additional personnel and related costs, higher due diligence costs of approximately $260,000, and costs associated with the implementation of a new financial systems platform of approximately $600,000, which was substantially completed during the second quarter of 2016.

Depreciation and Amortization. Depreciation and amortization increased approximately $5.2 million, or 31%, to $22.2 million for 2016 from $17.0 million for 2015. The increase primarily resulted from amortization of capitalized software development, amortization of intangible assets from recent acquisitions (including amortization of software acquired for resale), and depreciation expense associated with capital expenditures.

Other Income (Expense), Net. Other income (expense), net was income of approximately $581,000 for 2016 compared to $162,000 for 2015. The increase is primarily associated with a gain recorded in relation to the acquisition of all of the remaining outstanding stock of Nursing Registry Consultants Corporation (See Note 5 in the Notes to Consolidated Financial Statements for further discussion), an increase in interest income from investments in marketable securities and lower interest expense.

Income Tax Provision. The Company recorded a provision for income taxes of approximately $2.4 million for 2016 compared to $5.1 million for 2015. The Company s effective tax rate was approximately 39% for 2016 compared to approximately 37% for 2015. The decrease in income tax expense during 2016 is attributable to lower taxable income compared to the prior year period.

Net Income. Net income decreased approximately $4.8 million, or 56%, to $3.8 million for 2016 compared to $8.6 million for 2015. The decrease resulted from the factors mentioned above. Earnings per diluted share were $0.12 per share for 2016 compared to $0.28 per diluted share for 2015.

Adjusted EBITDA (a non-GAAP financial measure which we define as net income before interest, income taxes, stock based compensation, and depreciation and amortization) decreased approximately 12% to approximately $29.9 million for 2016 compared to $33.8 million for 2015. The decrease resulted from the factors mentioned above. See Reconciliation of Non-GAAP Financial Measures below for our reconciliation of this calculation to measures under US GAAP.

2015 Compared to 2014

Revenues, net. Revenues increased approximately $38.3 million, or 22%, to $209.0 million for 2015 from $170.7 million for 2014. A comparison of revenues by business segment is as follows (in thousands):

Revenues by Business Segment:	2015	2014	Percentage Change
Workforce	$ 161,289	$ 134,242	20%
Patient Experience	34,193	31,901	7%
Provider	13,520	4,547	197%
Total revenues, net	$ 209,002	$ 170,690	22%
% of Revenues			
Workforce	77%	79%	
Patient Experience	16%	19%	
Provider	7%	2%	

Revenues for HealthStream Workforce Solutions increased approximately $27.0 million, or 20%, over 2014. Revenues from our subscription-based workforce products increased by $26.0 million, or 20% over 2014 due to a higher number of subscribers and more courseware consumption by subscribers. Annualized revenue per implemented subscriber increased by 7%, to $36.96 per subscriber at the end of 2015 compared to $34.43 per subscriber at the end of 2014. Implemented subscribers increased by 9% to 4.48 million subscribers at the end of 2015 compared to 4.15 million subscribers at the end of 2014. Additionally, total subscribers increased by 8%, with 4.62 million total subscribers at December 31, 2015 compared to 4.28 million total subscribers at December 31, 2014.

Revenues for HealthStream Patient Experience Solutions increased approximately $2.3 million, or 7%, over 2014. Revenues from Patient Insights surveys, our survey research product that generates recurring revenues, increased approximately $2.8 million, or 12%, over 2014, primarily due to growth in survey volumes over the prior year. Revenues from other products, including surveys conducted on annual or bi-annual cycles and consulting/coaching services, collectively decreased by $554,000 or 7%, compared to 2014 due to fewer engagements.

Revenues for HealthStream Provider Solutions increased approximately $9.0 million, or 197%, over 2014. Revenues from the HLS acquisition, which was consummated on March 16, 2015, were approximately $8.5 million during 2015. Revenues from other products increased by approximately $431,000, or 9% over 2014.

Cost of Revenues (excluding depreciation and amortization). Cost of revenues increased approximately $15.3 million, or 21%, to $89.4 million for 2015 from $74.1 million for 2014. Cost of revenues as a percentage of revenues was approximately 43% of revenues for both 2015 and 2014. Cost of revenues for HealthStream Workforce Solutions increased approximately $10.3 million to $63.5 million and approximated 39% and 40% of revenues for HealthStream Workforce Solutions for 2015 and 2014, respectively. The increase in both amount and as a percentage of revenues is primarily associated with increased royalties paid by us resulting from growth in courseware subscription revenues, as well as increases in personnel expenses, stock based compensation, and other support costs. Cost of revenues for HealthStream Patient Experience Solutions increased approximately $2.2 million to $22.4 million and approximated 65% and 63% of revenues for HealthStream Patient Experience Solutions for 2015 and 2014, respectively. The increase in both amount and as a percentage of revenues is primarily the result of increased personnel costs, including personnel to support the growth in patient survey volume over the prior year, and increased stock based compensation. Cost of revenues for HealthStream Provider Solutions increased approximately $2.8 million to $3.5 million, and approximated 26% and 16% of revenues for HealthStream Provider Solutions for 2015 and 2014, respectively. The increase in both amount and as a percentage of revenue is primarily the result of the HLS acquisition.

Product Development. Product development expenses increased approximately $7.8 million, or 47%, to $24.2 million for 2015 from $16.5 million for 2014. Product development expenses as a percentage of revenues were approximately 12% and 10% of revenues for 2015 and 2014, respectively.

Product development expenses for HealthStream Workforce Solutions increased approximately $4.8 million and approximated 12% and 11% of revenues for HealthStream Workforce for 2015 and 2014, respectively. The increase in both amount and as a percentage of revenues is due to additional personnel expenses associated with new product development initiatives for our subscription-based products, as well as increased stock based compensation. Product development expenses for HealthStream Patient Experience Solutions increased approximately $1.0 million and approximated 7% and 4% of revenues for HealthStream Patient Experience Solutions in 2015 and 2014, respectively. The increase in both amount and as a percentage of revenues is due to additional personnel and related expenses compared to the prior year period. Product development expenses for HealthStream Provider Solutions increased approximately $2.0 million and approximated 18% and 11% of revenues for HealthStream Provider Solutions for 2015 and 2014, respectively. The increase in both amount and as a percentage of revenues is due primarily to the HLS acquisition.

Sales and Marketing. Sales and marketing expenses, including personnel costs, increased approximately $5.7 million, or 19%, to $35.6 million for 2015 from $29.9 million for 2014. Sales and marketing expenses as a percentage of revenues were approximately 17% and 18% of revenues for 2015 and 2014, respectively.

Sales and marketing expenses for HealthStream Workforce Solutions increased approximately $5.1 million and approximated 17% and 16% of revenues for HealthStream Workforce Solutions for 2015 and 2014, respectively. The increase in both amount and as a percentage of revenues is primarily due to additional personnel and related expenses, commissions, and expenses associated with our customer Summit, increased marketing spending, and increased stock based compensation. Sales and marketing expenses for HealthStream Patient Experience Solutions decreased approximately $1.7 million, and approximated 13% and 19% of revenues for HealthStream Patient Experience Solutions for 2015 and 2014, respectively. The decrease in amount and as a percentage of revenues is primarily due to fewer account management personnel compared to the prior year. Sales and marketing expenses for HealthStream Provider Solutions increased approximately $2.2 million and approximated 26% and 30% of revenues for HealthStream Provider Solutions for 2015 and 2014, respectively. The increase in amount is primarily due to the HLS acquisition.

Other General and Administrative Expenses. Other general and administrative expenses increased approximately $6.4 million, or 28%, to $29.3 million for 2015 from $22.9 million for 2014. Other general and administrative expenses as a percentage of revenues were approximately 14% and 13% of revenues for 2015 and 2014, respectively.

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Other general and administrative expenses for HealthStream Workforce Solutions increased approximately $253,000 over the prior year. The increase is primarily due to the HCCS acquisition, additional personnel, and increased other support costs. Other general and administrative expenses for HealthStream Patient Experience Solutions increased approximately $305,000 compared to the prior year period primarily due to increased facilities costs for a new patient interview center in Nashville, Tennessee. Other general and administrative expenses for HealthStream Provider Solutions increased approximately $2.1 million compared to the prior year period primarily due to the HLS acquisition. The unallocated corporate portion of other general and administrative expenses increased approximately $3.7 million over the prior year period, primarily associated with additional personnel, professional fees, stock based compensation, and other general expenses, as well as higher acquisition costs during 2015 than in 2014. Acquisition costs during 2015 approximated $1.1 million, of which $965,000 were associated with the HLS acquisition. Acquisition costs during 2014 approximated $762,000, of which $329,000 were associated with the HLS acquisition and $365,000 were associated with the HCCS acquisition.

Depreciation and Amortization. Depreciation and amortization increased approximately $6.1 million, or 55%, to $17.0 million for 2015 from $10.9 million for 2014. The increase primarily resulted from amortization of capitalized software development, amortization of intangible assets in relation to the acquisition of HLS, and depreciation expense associated with capital expenditures.

Other Income, Net. Other income, net was approximately $162,000 for 2015 compared to $146,000 for 2014. The increase is attributable to both interest income from investments in marketable securities and a gain on disposal of long lived assets, but was partially offset by higher interest expense from borrowings under a revolving credit facility during 2015 and losses from equity method investments.

Income Tax Provision. The Company recorded a provision for income taxes of approximately $5.1 million for 2015 compared to approximately $6.1 million for 2014. The Company s effective tax rate was approximately 37% for both 2015 and 2014. The decrease in income tax expense during 2015 is attributable to lower taxable income compared to the prior year period.

Net Income. Net income decreased approximately $1.8 million, or 17%, to $8.6 million for 2015 from $10.4 million for 2014. This decrease was driven by the factors set forth above. Earnings per diluted share were $0.28 per share for 2015, compared to $0.37 per diluted share for 2014.

Adjusted EBITDA (a non-GAAP financial measure which we define as net income before interest, income taxes, stock-based compensation, and depreciation and amortization) increased by 17% to approximately $33.8 million for 2015 compared to $28.9 million for 2014. This improvement was driven by the factors mentioned above. See Reconciliation of Non-GAAP Financial Measures in Management s Discussion and Analysis of Financial Condition and Results of Operations for a reconciliation of this calculation to measures under US GAAP and disclosure regarding why we believe Adjusted EBITDA provides useful information to investors.

Reconciliation of Non-GAAP Financial Measures

This report contains certain non-GAAP financial measures, including non-GAAP net income, non-GAAP operating income, and adjusted EBITDA, which are used by management in analyzing the Company s financial results and ongoing operational performance. These non-GAAP financial measures should not be considered as a substitute for, or superior to, measures of financial performance which are prepared in accordance with US GAAP and may be different from non-GAAP financial measures used by other companies.

In order to better assess the Company s financial results, management believes that adjusted EBITDA is a useful measure for evaluating the operating performance of the Company because adjusted EBITDA reflects net income adjusted for certain non-cash and non-operating items. The Company believes that adjusted EBITDA is also used by many investors and securities analysts to assess the Company s results from current operations. Adjusted EBITDA is a non-GAAP financial measure and should not be considered as a measure of financial performance under US GAAP. Because adjusted EBITDA is not a measurement determined in accordance with US GAAP, it is susceptible to varying calculations. Accordingly, adjusted EBITDA, as presented, may not be comparable to other similarly titled measures of other companies.

The Company understands that, although adjusted EBITDA is frequently used by investors and securities analysts in their evaluation of companies, this measure has limitations as an analytical tool, and should not be considered in isolation, or as a substitute for an analysis of the Company s results as reported under US GAAP.

Management addresses these inherent limitations associated with using adjusted EBITDA through disclosure of such limitations, presentation of our financial statements in accordance with US GAAP, and reconciliation of adjusted EBITDA to net income, the most directly comparable US GAAP measure.

In recent years, including the March 2014 acquisition of HCCS, the March 2015 acquisition of HLS, and the August 2016 acquisition of MAI, the Company has acquired businesses whose net tangible assets include deferred revenue. In accordance with GAAP reporting requirements, following the completion of any such acquisition, the Company may record a write-down of deferred revenue to fair value as defined in GAAP. If the Company is required to record a write-down of deferred revenue, it may result in lower recognized revenue, operating income and net income in subsequent periods.

In connection therewith, this report presents below non-GAAP revenues, non-GAAP operating income and non-GAAP net income, which in each such case reflects the corresponding GAAP figures adjusted to exclude the impact of the deferred revenue write-down

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associated with fair value accounting for acquired businesses as referenced above. Management believes that the presentation of these non-GAAP financial measures assists investors in understanding the Company s performance between periods by excluding the impact of this deferred revenue write-down and provides a useful measure of the ongoing performance of the Company. Both on a quarterly and year-to-date basis, the revenue for the acquired business is deferred and typically recognized over a one-to-two year period following the completion of any particular acquisition, so our GAAP revenues for this one-to-two year period will not reflect the full amount of revenues that would have been reported if the acquired deferred revenue was not written down to fair value. A reconciliation of these non-GAAP financial measures to the corresponding GAAP measures is set forth below.

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	2016	2015	2014
GAAP net income	$ 3,755	$ 8,621	$ 10,394
Interest income	(574)	(401)	(265)
Interest expense	102	188	56
Income tax provision	2,393	5,098	6,127
Stock based compensation expense	1,968	3,280	1,625
Depreciation and amortization	22,207	16,997	10,931
Adjusted EBITDA	$ 29,851	$ 33,783	$ 28,868
GAAP operating income	$ 5,567	$ 13,557	$ 16,375
Adjustment for deferred revenue write-down	3,838	6,822	1,465
Non-GAAP operating income	$ 9,405	$ 20,379	$ 17,840
GAAP net income	$ 3,755	$ 8,621	$ 10,394
Adjustment for deferred revenue write-down, net of tax	2,345	4,287	921
Non-GAAP net income	$ 6,100	$ 12,908	$ 11,315

FINANCIAL OUTLOOK FOR 2017

The Company provides projections and other forward-looking information in this Financial Outlook for 2017 section within Management s Discussion and Analysis of Financial Condition and Results of Operations. This section contains many forward-looking statements, particularly relating to the Company s future financial performance. These forward-looking statements are estimates based on information currently available to the Company, are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995 and are subject to the precautionary statements set forth in the introduction in Part I of this Annual Report on Form 10-K and the risks and uncertainties described in Item 1A, Risk Factors and elsewhere in this document. Actual results are likely to differ, and in the past have differed, materially from those forecast by the Company, depending on the outcome of various factors, including, but not limited to, those set forth in Item 1A, Risk Factors.

For 2017, we anticipate that consolidated revenues will grow 10 to 14 percent as compared to 2016. We anticipate that revenue growth in our Workforce Solutions segment will be in the three to seven percent range and five to eight percent in our Patient Experience Solutions segment. We anticipate our Provider Solutions segment s revenue to grow 66 to 72 percent as compared to 2016.

We anticipate operating income for 2017 to increase between 50 and 65 percent as compared to 2016.

We anticipate that capital expenditures will be between $15 million and $17 million during 2017. We expect the annual effective income tax rate to range between 39 percent and 41 percent for 2017.

The aforementioned guidance does not include the impact from any acquisitions that we may complete during 2017.

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SELECTED QUARTERLY OPERATING RESULTS

The following tables set forth selected statements of income data for each of the four quarters in the periods ended December 31, 2016 and December 31, 2015, respectively. The information for each quarter has been prepared on the same basis as the audited statements included in other parts of this report and, in our opinion, includes all adjustments, consisting of only normal recurring adjustments, necessary for a fair presentation of the results of operations for these periods. You should read this information in conjunction with HealthStream s Consolidated Financial Statements and related notes thereto included elsewhere in this report. The operating results for any quarter are not necessarily indicative of the results to be expected in the future.

Revenues from our subscription-based products are recognized ratably over the subscription term. Survey and research revenues are impacted by seasonal factors resulting from the volume, timing, and frequency of survey cycles.

	Quarter Ended			
	March 31, 2016	June 30, 2016	September 30, 2016	December 31, 2016
	(In thousands, except per share data)			
STATEMENT OF INCOME DATA:				
Revenues, net	$ 54,078	$ 54,793	$ 58,367	$ 58,737
Total operating costs and expenses	51,592	52,477	57,081	59,258
Income (loss) from operations	2,486	2,316	1,286	(521)
Net income (loss)	$ 1,501	$ 1,403	$ 1,162	$ (311)
Net income (loss) per share [1]:				
Basic	$ 0.05	$ 0.04	$ 0.04	$ (0.01)
Diluted	$ 0.05	$ 0.04	$ 0.04	$ (0.01)
Weighted average shares of common stock outstanding:				
Basic	31,666	31,736	31,739	31,743
Diluted	31,974	32,071	32,107	31,743

	Quarter Ended			
	March 31, 2015	June 30, 2015	September 30, 2015	December 31, 2015
	(In thousands, except per share data)			
STATEMENT OF INCOME DATA:				
Revenues, net	$ 47,156	$ 52,145	$ 53,835	$ 55,866
Total operating costs and expenses	42,366	49,581	49,510	53,988
Income from operations	4,790	2,564	4,325	1,878
Net income	$ 2,722	$ 1,473	$ 2,614	$ 1,811

Net income per share [1]:				
Basic	$ 0.10	$ 0.05	$ 0.08	$ 0.06
Diluted	$ 0.10	$ 0.05	$ 0.08	$ 0.06
Weighted average shares of common stock outstanding:				
Basic	27,703	29,234	31,643	31,646
Diluted	28,068	29,617	32,029	32,031

(1) Due to the nature of interim earnings per share calculations, the sum of quarterly earnings per share amounts may not equal the reported earnings per share for the full year.

Liquidity and Capital Resources

Net cash provided by operating activities was approximately $24.2 million during 2016 and $34.9 million during 2015. The primary sources of cash were generated from receipts from the sales of our products and services. The decrease in cash flows from operating activities was significantly impacted by increases in accounts receivable, resulting from slower collections in our Provider Solutions segment, as well as reduced deferred revenue balances compared to the prior year. The number of days sales outstanding (DSO) was 66 days for 2016 and 61 days for 2015. The Company calculates DSO by dividing the average accounts receivable balance (excluding unbilled and other receivables) by average daily revenues for the year. The Company s primary sources of cash were receipts generated from the sales of our products and services. The primary uses of cash to fund operations included personnel expenses, sales commissions, royalty payments, payments for contract labor and other direct expenses associated with delivery of our products and services, and general corporate expenses.

Net cash used in investing activities was approximately $56.7 million during 2016 and $134.9 million during 2015. During 2016, the Company utilized $55.3 million (net of cash acquired) for acquisitions, purchased $107.0 million of marketable securities, spent $9.7 million for capitalized software development, and purchased $5.1 million of property and equipment. These uses of cash were partially offset by maturities of marketable securities of $119.4 million and proceeds from the sale of long lived assets of $975,000. During 2015, the Company utilized $88.1 million (net of cash acquired) for business combinations, purchased $84.2 million of marketable securities, spent $7.3 million for capitalized software development, purchased $8.1 million of property and equipment, and made $2.0 million in non-marketable equity investments. These uses of cash were partially offset by maturities of marketable securities of $54.8 million.

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Cash provided by financing activities was approximately $46,000 during 2016 and $100.0 million during 2015. During 2016, the primary source of cash from financing activities resulted from $217,000 of excess tax benefits from equity awards and $145,000 from the exercise of employee stock options. The primary uses of cash during 2016 related to $316,000 for payments of payroll taxes from stock based compensation arrangements. During 2015, the primary sources of cash from financing activities resulted from $98.0 million in proceeds from the issuance of 3.9 million shares of our common stock in our underwritten public offering that was completed on May 28, 2015, $3.0 million of excess tax benefits from equity awards, and $328,000 of proceeds from the exercise of employee stock options. The primary uses of cash during 2015 related to payments of payroll taxes from stock based compensation arrangements of $756,000 and earn-outs for prior business combinations of $633,000.

Our balance sheet reflects positive working capital of $82.5 million at December 31, 2016 compared to $120.4 million at December 31, 2015. The decrease in working capital was primarily due to the use of cash to fund acquisitions of approximately $55.3 million and slower collections from customers resulting in higher accounts receivable balances. The Company s primary source of liquidity is $103.2 million of cash and cash equivalents and marketable securities. The Company also has a $50.0 million revolving credit facility loan agreement, all of which was available at December 31, 2016.

We believe that our existing cash and cash equivalents, marketable securities, cash generated from operations, and available borrowings under our revolving credit facility will be sufficient to meet anticipated working capital needs, new product development and capital expenditures for at least the next 12 months.

The Company s growth strategy includes acquiring businesses that provide complementary product and services. It is anticipated that future acquisitions, if any, would be effected through cash consideration, stock consideration, or a combination of both. The issuance of our stock as consideration for an acquisition or to raise additional capital could have a dilutive effect on earnings per share and could adversely affect our stock price. The revolving credit facility contains financial covenants and availability calculations designed to set a maximum leverage ratio of outstanding debt to consolidated EBITDA (as defined in our credit facility) and an interest coverage ratio of consolidated EBITDA to interest expense. Therefore, the maximum borrowings against the revolving credit facility would be dependent on the covenant values at the time of borrowing. As of December 31, 2016, the Company was in material compliance with all covenants. There can be no assurance that amounts available for borrowing under our revolving credit facility will be sufficient to consummate any possible acquisitions, and we cannot assure you that if we need additional financing that it will be available on terms favorable to us, or at all. Failure to generate sufficient cash flow from operations or raise additional capital when required in sufficient amounts and on terms acceptable to us could harm our business, financial condition and results of operations.

Off-Balance Sheet Arrangements and Contractual Obligations

The Company s off-balance sheet arrangements primarily consist of operating leases, contractual obligations, and our revolving credit facility, which is described further in Note 13 to the Company s consolidated financial statements contained elsewhere in this report.

The following table presents a summary of future anticipated payments due by the Company under contractual obligations with firm minimum commitments as of December 31, 2016, excluding amounts already recorded in the consolidated balance sheets (in thousands):

	Payments due by period

	Less than 1 year	1-3 years	3-5 years	More than 5 years	Total
Operating leases	$ 5,044	$ 6,242	$ 1,853	$ 2,748	$ 15,887
Purchase obligations	416	61			477
Total	$ 5,460	$ 6,303	$ 1,853	$ 2,748	$ 16,364

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers (Topic 606)*, which supersedes the revenue recognition requirements in Topic 605, *Revenue Recognition*, and most industry-specific revenue recognition guidance throughout the Industry Topics of the Accounting Standards Codification. The updated guidance states that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance also provides for additional disclosures with respect to revenues and cash flows arising from contracts with customers. The standard will be effective for the first interim period within annual reporting periods beginning after December 15, 2017, and the Company currently anticipates adopting the standard using the modified retrospective approach effective January 1, 2018. The Company is in the process of implementing the standard, and has identified several key provisions that may result in changes to current accounting policies, systems and processes, and internal controls, including but not limited to the following: 1) Determining the relative selling price for software-as-a-service agreements, software licenses, software maintenance, and professional services in order to assign value to the separate performance obligations within a contract. Certain existing right to use arrangements are recognized over time because VSOE cannot be established, but may result in earlier revenue recognition under the new standard. 2) Capitalizing costs to acquire contracts, such as sales commissions, is not a current accounting policy; therefore we expect historical sales commissions, which have been expensed as incurred, will need to be evaluated for capitalization; 3) Ensuring the Company s financial systems can record, calculate, summarize, and report the necessary information required by the standard, which will require additional investments in technology and resources. The Company is not currently able to quantify the financial impact of the Company s adoption of this accounting standard on its future consolidated financial statements, but does anticipate adjustments to retained earnings upon adoption.

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842),* which requires lessees to recognize assets and liabilities for most leases. The recognition, measurement and presentation of expenses and cash flows arising from a lease by a lessee is not expected to significantly change under such guidance; however, the Company is currently reviewing this standard to determine the method of adoption and to assess the impact on its future consolidated financial statements. The standard will be effective for the first interim period within annual reporting periods beginning after December 15, 2018, and early adoption is permitted.

In March 2016, the FASB issued ASU 2016-09, *Compensation Stock Compensation (Topic 718),* which serves to simplify several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. The standard will be effective for the first interim period within annual reporting periods beginning after December 15, 2016, and early adoption is permitted in any interim or annual period. The Company does not expect the adoption will have a material effect on its future consolidated financial statements.

In March 2016, the FASB issued ASU 2016-01, *Financial Instruments Overall (Sub Topic 825-10)*, which addresses certain aspects of the recognition, measurement, presentation, and disclosure of financial instruments. The guidance will, among other things, require equity method investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income. The standard will be effective for the first interim period within annual reporting periods beginning after December 15, 2017, and early adoption is permitted for only limited aspects of such guidance. The Company is currently reviewing this standard to determine the method of adoption and to assess the impact on its future consolidated financial statements.

Item 7A. ***Quantitative and Qualitative Disclosures about Market Risk***

The Company is exposed to market risk from changes in interest rates. We do not have any foreign currency exchange rate risk or commodity price risk. As of December 31, 2016, the Company had no outstanding debt. We may become subject to interest rate market risk associated with any future borrowings under our revolving credit facility. The interest rate under the revolving credit facility varies depending on the interest rate option selected by the Company plus a margin determined in accordance with a pricing grid. We are exposed to market risk with respect to our cash and investment balances, which approximated $103.2 million at December 31, 2016. Assuming a hypothetical 10% decrease in interest rates, interest income from cash and investments would decrease on an annualized basis by approximately $80,000.

The Company s investment policy and strategy is focused on investing in highly rated securities, with the objective of minimizing the potential risk of principal loss. The Company s policy limits the amount of credit exposure to any single issuer and sets limits on the average portfolio maturity.

The above market risk discussion and the estimated amounts presented are forward-looking statements of market risk assuming the occurrence of certain adverse market conditions. Actual results in the future may differ materially from those projected as a result of actual developments in the market.

Item 8. ***Financial Statements and Supplementary Data***

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Shareholders of

HealthStream, Inc.

We have audited the accompanying consolidated balance sheets of HealthStream, Inc. as of December 31, 2016 and 2015, and the related consolidated statements of income, comprehensive income, shareholders equity, and cash flows for each of the three years in the period ended December 31, 2016. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of HealthStream, Inc. at December 31, 2016 and 2015, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2016, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), HealthStream, Inc. s internal control over financial reporting as of December 31, 2016, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework) and our report dated February 27, 2017 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Nashville, Tennessee

February 27, 2017

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Shareholders of

HealthStream, Inc.

We have audited HealthStream, Inc. s internal control over financial reporting as of December 31, 2016, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework) (the COSO criteria). HealthStream, Inc. s management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management s Annual Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company s internal control over financial reporting based on our audit.

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

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

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

In our opinion, HealthStream, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2016, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the 2016 consolidated financial statements of HealthStream, Inc. and our report dated February 27, 2017 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Nashville, Tennessee

February 27, 2017

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HEALTHSTREAM, INC.

CONSOLIDATED BALANCE SHEETS

(In thousands)

	December 31, 2016	December 31, 2015
ASSETS		
Current assets:		
Cash and cash equivalents	$ 49,634	$ 82,010
Marketable securities	53,540	66,976
Accounts receivable, net of allowance for doubtful accounts of $863 and $303 at December 31, 2016 and 2015, respectively	44,805	36,348
Accounts receivable - unbilled	2,581	1,998
Prepaid royalties, net of amortization	18,183	14,036
Other prepaid expenses and other current assets	8,694	8,169
Total current assets	177,437	209,537
Property and equipment, net	10,245	12,471
Capitalized software development, net of accumulated amortization of $31,787 and $24,130 at December 31, 2016 and 2015, respectively	16,310	13,955
Goodwill	109,765	83,073
Intangible assets, net of accumulated amortization of $16,445 and $8,685 at December 31, 2016 and 2015, respectively	78,364	55,966
Non-marketable equity investments	3,276	3,640
Other assets	603	927
Total assets	$ 396,000	$ 379,569
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 3,127	$ 4,616
Accrued royalties	13,161	9,053
Accrued liabilities	8,146	7,003
Accrued compensation and related expenses	1,994	3,308
Deferred revenue	68,542	65,098
Total current liabilities	94,970	89,078
Deferred tax liabilities	5,968	4,763
Deferred revenue, noncurrent	7,859	4,350
Other long term liabilities	1,095	1,058
Commitments and contingencies		
Shareholders equity:		
Common stock, no par value, 75,000 shares authorized; 31,748 and 31,647 shares issued and outstanding at December 31, 2016 and 2015, respectively	280,813	278,799

Retained earnings		5,346		1,591
Accumulated other comprehensive loss		(51)		(70)
Total shareholders equity		286,108		280,320
Total liabilities and shareholders equity	$	396,000	$	379,569

See accompanying notes to the consolidated financial statements.

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HEALTHSTREAM, INC.

CONSOLIDATED STATEMENTS OF INCOME

(In thousands, except per share data)

	For the Year Ended December 31,		
	2016	**2015**	**2014**
Revenues, net	$ 225,974	$ 209,002	$ 170,690
Operating costs and expenses:			
Cost of revenues (excluding depreciation and amortization)	96,634	89,386	74,145
Product development	28,897	24,214	16,463
Sales and marketing	39,004	35,589	29,867
Other general and administrative expenses	33,665	29,259	22,909
Depreciation and amortization	22,207	16,997	10,931
Total operating costs and expenses	220,407	195,445	154,315
Operating income	5,567	13,557	16,375
Other income, net	581	162	146
Income before income tax provision	6,148	13,719	16,521
Income tax provision	2,393	5,098	6,127
Net income	$ 3,755	$ 8,621	$ 10,394
Net income per share:			
Basic	$ 0.12	$ 0.29	$ 0.38
Diluted	$ 0.12	$ 0.28	$ 0.37
Weighted average shares of common stock outstanding:			
Basic	31,721	30,057	27,570
Diluted	32,068	30,436	28,023

See accompanying notes to the consolidated financial statements.

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HEALTHSTREAM, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(In thousands)

	For the Year Ended December 31,		
	2016	**2015**	**2014**
Net income	$ 3,755	$ 8,621	$ 10,394
Other comprehensive income, net of taxes:			
Unrealized gain (loss) on marketable securities	19	(33)	(6)
Total other comprehensive income (loss)	19	(33)	(6)
Comprehensive income	$ 3,774	$ 8,588	$ 10,388

See accompanying notes to the consolidated financial statements.

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HEALTHSTREAM, INC.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

(In thousands)

	Common Stock		Retained Earnings (Accumulated	Accumulated Other Comprehensive Income	Total Shareholders
	Shares	Amount	Deficit)	(Loss)	Equity
Balance at December 31, 2013	27,327	$ 166,888	$ (17,424)	$ (31)	$ 149,433
Net income			10,394		10,394
Comprehensive loss				(6)	(6)
Issuance of common stock in acquisition	82	2,246			2,246
Stock based compensation		1,625			1,625
Tax benefits from equity awards		3,234			3,234
Common stock issued under stock plans, net of shares withheld for employee taxes	268	933			933
Balance at December 31, 2014	27,677	174,926	(7,030)	(37)	167,859
Net income			8,621		8,621
Comprehensive loss				(33)	(33)
Issuance of common stock	3,870	98,014			98,014
Stock donated to Company	(54)				0
Stock based compensation		3,280			3,280
Tax benefits from equity awards		3,008			3,008
Common stock issued under stock plans, net of shares withheld for employee taxes	154	(429)			(429)
Balance at December 31, 2015	31,647	278,799	1,591	(70)	280,320
Net income			3,755		3,755
Comprehensive income				19	19
Stock based compensation	101	1,968			1,968
Tax benefits from equity awards		217			217
Common stock issued under stock plans, net of shares withheld for employee taxes		(171)			(171)
Balance at December 31, 2016	31,748	$ 280,813	$ 5,346	$ (51)	$ 286,108

See accompanying notes to the consolidated financial statements.

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HEALTHSTREAM, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

	For the Year Ended December 31, 2016	2015	2014
OPERATING ACTIVITIES:			
Net income	$ 3,755	$ 8,621	$ 10,394
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	22,207	16,997	10,931
Deferred income taxes	1,786	392	1,324
Share based compensation expense	1,968	3,280	1,625
Excess tax benefits from equity awards	(217)	(3,008)	(3,234)
Provision for doubtful accounts	640	284	237
(Gain) loss on non-marketable equity investments	(121)	117	65
Gain on sale of long-lived assets		(72)	
Other	1,026	1,401	1,394
Changes in assets and liabilities, net of business combinations:			
Accounts and unbilled receivables	(6,079)	(736)	(6,690)
Prepaid royalties	(4,008)	(1,006)	(4,174)
Other prepaid expenses and other current assets	(1,462)	(1,372)	(2,022)
Other assets	305	1,110	(1,761)
Accounts payable	(1,319)	(137)	2,442
Accrued royalties	3,691	(202)	820
Accrued liabilities, accrued compensation and related expenses, and other long-term liabilities	(884)	3,075	5,434
Deferred revenue	2,946	6,173	17,471
Net cash provided by operating activities	24,234	34,917	34,256
INVESTING ACTIVITIES:			
Business combinations, net of cash acquired	(55,255)	(88,075)	(12,298)
Proceeds from maturities of marketable securities	119,395	54,799	52,625
Purchases of marketable securities	(106,965)	(84,228)	(44,341)
Payments to acquire equity method investments		(1,000)	(325)
Payments to acquire cost method investments		(1,000)	(1,000)
Proceeds for sale of long lived assets	975		
Payments associated with capitalized software development	(9,721)	(7,265)	(5,658)
Purchases of property and equipment	(5,085)	(8,094)	(4,544)
Net cash used in investing activities	(56,656)	(134,863)	(15,541)

FINANCING ACTIVITIES:

Proceeds from issuance of common stock		98,014	
Proceeds from exercise of stock options	145	328	1,094
Proceeds from borrowings under revolving line of credit facility		28,000	
Repayments under revolving line of credit facility		(28,000)	
Taxes paid related to net settlement of equity awards	(316)	(756)	(161)
Excess tax benefits from equity awards	217	3,008	3,234
Payment of earn-outs related to business combinations		(633)	(424)
Net cash provided by financing activities	46	99,961	3,743
Net increase (decrease) in cash and cash equivalents	(32,376)	15	22,458
Cash and cash equivalents at beginning of year	82,010	81,995	59,537
Cash and cash equivalents at end of year	$ 49,634	$ 82,010	$ 81,995
SUPPLEMENTAL CASH FLOW INFORMATION:			
Interest paid	$ 76	$ 190	$ 56
Income taxes paid	$ 2,496	$ 2,648	$ 1,641
NON-CASH INVESTING AND FINANCING ACTIVITIES:			
Receivable from sale of long-lived assets	$	$ 975	0
Issuance of common stock in connection with business combinations	$	$	$ 2,246

See accompanying notes to the consolidated financial statements.

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HEALTHSTREAM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Reporting Entity and Segments

HealthStream, Inc. (the Company) was incorporated in 1990 as a Tennessee corporation and is headquartered in Nashville, Tennessee. The Company operates in three segments: HealthStream Workforce Solutions, HealthStream Patient Experience Solutions, and HealthStream Provider Solutions. Workforce Solutions products consist of SaaS-based services and subscription-based solutions to meet the ongoing training, certification, assessment and development needs of the healthcare community. These solutions provide, deliver and track computer based education for our customers in the United States through our software-as-a-service (SaaS) model. Patient Experience products offer healthcare organizations a wide range of quality and satisfaction surveys, consulting services, analyses of survey results, and other research-based services. Provider Solutions products offer healthcare organizations software applications for administering and tracking provider credentialing, privileging, call center and enrollment.

Recently Adopted Accounting Standards

The Company adopted Accounting Standards Update (ASU) 2015-16, *Business Combinations (Topic 805)* in January 2016. Under the provisions of the revised guidance, acquirers in a business combination must recognize adjustments to provisional amounts that are identified during the measurement period in the reporting period in which the adjustment amounts are determined. The acquirer must record, in the same period s financial statements, the effect on earnings of changes in depreciation, amortization, or other income effects, if any, as a result of the change to the provisional amounts, calculated as if the accounting had been completed at the acquisition date. The Company recorded a measurement period adjustment during the period ended March 31, 2016. See Note 5 Business Combinations for further discussion.

Recognition of Revenue

Revenues are derived from providing services through our SaaS-based workforce development platform products, courseware subscriptions, provision of survey and research services, sales of software licensing arrangements, software maintenance and support, professional services, custom courseware development and other education and training services.

The Company recognizes revenue when it is realized or realizable and earned. The Company considers revenue realized or realizable and earned when persuasive evidence of an arrangement exists, prices are fixed or determinable, services and products are provided to the customer and collectability is probable or reasonably assured.

Revenue recognized from software and other arrangements is allocated to each element of the arrangement based on the relative fair values of the elements. While elements include software products and post contract customer support, the fair value of each element is based on vendor specific objective evidence (VSOE). For installed software products, if fair value cannot be determined for each undelivered element of the arrangement, all revenue from the arrangement is deferred until fair value can be determined or until all elements of the arrangement are delivered and customer acceptance has occurred. Sales of the Company s SaaS-based workforce development platform products include customer support, implementation services, and training; therefore all revenues are deferred until the SaaS-based product is implemented, at which time revenues are recognized ratably over the subscription service period. In the event that circumstances occur, which give rise to uncertainty regarding the collectibility of contracted amounts, revenue recognition is suspended until such uncertainty is resolved. Fees for these services are billed on either a monthly, quarterly, or annual basis.

Revenues derived from the delivery of services through the Company s SaaS-based workforce development platform products and courseware subscriptions are recognized ratably over the term of the subscription service agreement or over the historical usage period, if usage typically differs from the subscription period. Other training revenues are generally recognized upon the completion of training.

Revenues derived from the license of installed software products are recognized using the residual method upon delivery of the software, when VSOE of fair value for the undelivered elements within the contract can be established. If the Company cannot objectively determine the fair value of each undelivered element based on the VSOE of fair value, the Company defers revenue recognition until all elements are delivered, all services have been performed, or until fair value can be objectively determined. Software support and maintenance revenues are recognized ratably over the term of the related agreement.

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HEALTHSTREAM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Revenues recognized from the Company s survey and research services are determined using both the proportional performance method and the completed contract method. Revenues are generally earned over the estimated survey cycle, which typically ranges from less than one month to up to five months. The survey cycle is generally initiated based on the receipt of the first survey response and runs through provision of related survey reports to the customer. If survey results are not available to the customer during the survey fielding cycle, revenues are recognized at time of report delivery. Revenues for coaching and consulting engagements are recognized using the proportional performance method over the term of the underlying contract. Fees for survey services are billed upon initiation of the survey cycle, with progress billings made throughout the survey cycle. Fees for coaching and consulting engagements are billed upon initiation of the engagement with progress billings throughout the term of the contract.

Revenues from professional services and courseware development services are recognized upon the completion of performance milestones and deliverables using the proportional performance method. All other revenues are recognized as the related services are performed or products are delivered. Fees for these services are generally billed at project initiation and upon completion of various milestones.

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its subsidiaries, all of which are wholly-owned. All inter-company accounts and transactions have been eliminated in consolidation.

Use of Estimates

The consolidated financial statements are prepared in accordance with U.S. generally accepted accounting principles. These accounting principles require management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates and such differences could be material to the consolidated financial statements.

Cash Equivalents

The Company considers cash equivalents to be unrestricted, highly liquid investments with initial maturities of less than three months.

Marketable Securities

Marketable securities are classified as available for sale and are stated at fair market value, with the unrealized gains and losses, net of tax, reported in other comprehensive income (loss) on the accompanying consolidated balance sheets. Realized gains and losses and declines in market value judged to be other than temporary on investments in marketable securities are included in interest and other income on the accompanying consolidated statements of income. The cost of securities sold is based on the specific identification method. Interest and dividends on securities classified as available for sale are included in other income (expense) on the accompanying consolidated statements of income. Premiums and discounts are amortized over the life of the related available for sale security as an adjustment to yield using the effective interest method.

Accounts Receivable-Unbilled

Accounts receivable-unbilled represents the following: 1) revenue earned and recognized on contracts accounted for using the proportional performance method for which invoices have not been generated or contractual billing dates have not been reached; and 2) the difference between billings for contracts containing escalated pricing over the term of the agreement and the recognition of revenue ratably over the subscription period.

Deferred Revenue

Deferred revenue represents amounts that have been billed or collected in advance of revenue recognition. The Company typically invoices customers in quarterly, bi-annual, or annual installments, and occasionally customers will pay for multi-year contracts in advance. Deferred revenue is reduced as the revenue recognition criteria are met.

Prepaid Royalties

Prepaid royalties represents advance payments associated with the sale of third party products, such as courseware subscriptions. Royalties are typically paid in advance at the commencement of the revenue cycle, or periodically throughout the revenue cycle, such as quarterly, bi-annual, or annual installments. Royalty payments are amortized over the term of the underlying contracts, which generally range from 12 to 36 months, in order to match the direct royalty costs to the same period the subscription revenue is recognized. Amortization of royalties is included under the caption cost of revenues (excluding depreciation and amortization) in the accompanying consolidated statements of income.

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HEALTHSTREAM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Allowance for Doubtful Accounts

The Company estimates its allowance for doubtful accounts using a specific identification method in which management considers the facts and circumstances surrounding each potentially uncollectible receivable. An allowance is also maintained for accounts that are not specifically identified that may become uncollectible in the future. Uncollectible receivables are written-off in the period management believes it has exhausted every opportunity to collect payment from the customer. Bad debt expense is recorded when events or circumstances indicate an additional allowance is required based on the Company s specific identification approach.

Changes in the allowance for doubtful accounts and the amounts charged to bad debt expense for the years ended December 31, were as follows (in thousands):

	Allowance Balance at Beginning of Period	Charged to Costs and Expenses	Write-offs	Allowance Balance at End of Period
2016	$ 303	$ 640	$ (80)	$ 863
2015	$ 331	$ 284	$ (312)	$ 303
2014	$ 211	$ 237	$ (117)	$ 331

Capitalized Software Development

Capitalized software development is stated on the basis of cost, and is presented net of accumulated amortization. The Company capitalizes costs incurred during the software development phase for projects when such costs are material. These assets are amortized using the straight-line method, generally ranging between three to five years. The Company capitalized approximately $10.0 million and $7.3 million during 2016 and 2015, respectively. Amortization of capitalized software development was approximately $7.7 million and $6.2 million during 2016 and 2015, respectively. Maintenance and operating costs are expensed as incurred. As of December 31, 2016 and 2015, there were no capitalized software development costs for computer software developed for resale.

Fair Value Measurements

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in the principal or most advantageous market in an orderly transaction between market participants at the measurement date. The fair value hierarchy prioritizes the inputs to valuation techniques used in measuring fair value. There are three levels to the fair value hierarchy based on the reliability of inputs, as follows:

Level 1 Observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2 Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly.

Level 3 Unobservable inputs in which little or no market data exists, therefore requiring the Company to develop its own assumptions.

The Company evaluates assets and liabilities subject to fair value measurements on a recurring basis to determine the appropriate level at which to classify them for each reporting period. This determination requires significant judgments to be made by the Company. At December 31, 2016 and 2015, our assets measured at fair value on a recurring basis consisted of marketable securities, which are classified as available for sale (see Note 4 Marketable Securities). The Company did not have any financial liabilities that were subject to fair value measurements as of such dates.

Property and Equipment

Property and equipment are stated on the basis of cost. Depreciation and amortization are provided on the straight-line method over the following estimated useful lives, except for assets under capital leases and leasehold improvements, which are amortized over the shorter of the estimated useful life or their respective lease term.

	Years
Furniture and fixtures	5-10
Equipment	3-5

HEALTHSTREAM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Goodwill and Intangible Assets

Goodwill represents the excess of purchase price in a business combination over the fair value of the net identifiable assets acquired. The carrying amount of our goodwill is evaluated for impairment at least annually during the fourth quarter and whenever events or changes in facts or circumstances indicate that impairment may exist. In accordance with ASC 350, *Intangibles Goodwill and Other*, companies may opt to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. A qualitative assessment includes factors such as financial performance, industry and market metrics, and other factors affecting the reporting unit. If this assessment concludes that is more likely than not that the fair value of a reporting unit exceeds its carrying value, then goodwill is not considered impaired and no further impairment testing is required. Conversely, if the qualitative assessment concludes that it is more likely than not that the fair value of a reporting unit is less than its carrying value, we must then compare the fair value of the reporting unit to its carrying value. The Company determines fair value of the reporting units using both income and market based models. These models require the use of various assumptions relating to cash flow projections, growth rates, discount rates and terminal value calculations. The Company did not recognize any impairment charges for the years ended December 31, 2016, 2015 or 2014.

As of December 31, 2016, intangible assets with remaining unamortized balances include contract rights and customer relationships, internally-developed technology and patents, non-competition agreements, and trade names. These intangible assets are considered to have definite useful lives and are being amortized on a straight line basis over periods typically ranging between three and fifteen years. The weighted average amortization period for definite lived intangible assets as of December 31, 2016 was 11.1 years. Intangible assets are reviewed for impairment whenever events or changes in facts or circumstances indicate that the carrying amount of the assets may not be recoverable. There were no impairments identified or recorded for the years ended December 31, 2016, 2015, or 2014.

Long-Lived Assets

Long-lived assets to be held for use are reviewed for events or changes in facts and circumstances, both internally and externally, which may indicate that an impairment of long-lived assets held for use is present. The Company measures any impairment using observable market values or discounted future cash flows from the related long-lived assets. The cash flow estimates and discount rates incorporate management s best estimates, using appropriate and customary assumptions and projections at the date of evaluation. Management periodically evaluates whether the carrying value of long-lived assets, including intangible assets, property and equipment, capitalized software development, and other assets will be recoverable. There were no impairments identified or recorded for the years ended December 31, 2016, 2015, or 2014.

Non-Marketable Equity Investments

Non-marketable equity investments are accounted for using the equity method when the Company can exercise significant influence over the investee. Investments for which the Company is not able to exercise significant influence over the investee are accounted for under the cost method. The proportionate share of income or loss from equity method investments are recorded under the caption other income, net in the accompanying consolidated statements of income.

Financial Instruments

The Company has various financial instruments, including cash and cash equivalents, accounts receivable, accounts receivable-unbilled, accounts payable, accrued liabilities, and deferred revenue. The carrying amounts of these financial instruments approximate fair value because of the short term maturity or short term nature of such instruments. The Company also has marketable securities, which are recorded at approximate fair value based on quoted market prices or alternative pricing sources (see Note 4 Marketable Securities).

Advertising

The Company expenses the costs of advertising as incurred. Advertising expense for the years ended December 31, 2016, 2015, and 2014 was approximately $1.0 million, $1.1 million, and $0.7 million, respectively.

Shipping and Handling Costs

Shipping and handling costs that are associated with our products and services are included in cost of revenues.

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HEALTHSTREAM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Income Taxes

Income taxes are accounted for using the asset and liability method, whereby deferred tax assets and liabilities are determined based on the temporary differences between the financial statement and tax bases of assets and liabilities measured at tax rates that will be in effect for the year in which the differences are expected to affect taxable income. Management evaluates all available evidence, both positive and negative, to determine whether, based on the weight of that evidence, a valuation allowance is needed. Future realization of the tax benefit of an existing deductible temporary difference or carryforward ultimately depends on the existence of sufficient taxable income of the appropriate character within the carryback or carryforward period available under the tax law. There are four possible sources of taxable income that may be available under the tax law to realize a tax benefit for deductible temporary differences and carryforwards: 1) future reversals of existing taxable temporary differences, 2) future taxable income exclusive of reversing temporary differences and carryforwards, 3) taxable income in prior carryback year(s) if carryback is permitted under the tax law, and 4) tax-planning strategies that would, if necessary, be implemented to realize deductible temporary differences or carryforwards prior to their expiration. Management reviews the realizability of its deferred tax assets each reporting period to identify whether any significant changes in circumstances or assumptions have occurred that could materially affect the realizability of deferred tax assets. As of December 31, 2016, the Company had established a valuation allowance of $654,000 for the portion of its net deferred tax assets that are not more likely than not expected to be realized.

The Company accounts for income tax uncertainties using a more-likely-than-not recognition threshold based on the technical merits of the tax position taken. Tax positions that meet the more-likely-than-not recognition threshold are measured in order to determine the tax benefit to be recognized in the financial statements. The Company expenses any penalties or interest associated with tax obligations as general and administrative expenses and interest expense, respectively.

Earnings Per Share

Basic earnings per share is computed by dividing the net income available to common shareholders for the period by the weighted average number of common shares outstanding during the period. Diluted earnings per share is computed by dividing the net income for the period by the weighted average number of common and common equivalent shares outstanding during the period. Common equivalent shares are composed of incremental common shares issuable upon the exercise of stock options and restricted share units subject to vesting. The dilutive effect of common equivalent shares is included in diluted earnings per share by application of the treasury stock method. Common equivalent shares that have an anti-dilutive effect on diluted net income per share have been excluded from the calculation of diluted weighted average shares outstanding for the years ended December 31, 2016, 2015, and 2014.

Concentrations of Credit Risk and Significant Customers

The Company s credit risks relate primarily to cash and cash equivalents, marketable securities and accounts receivable. The Company places its temporary excess cash investments in high quality, short-term money market instruments. At times, such investments may be in excess of the FDIC insurance limits. Marketable securities consists primarily of investment grade corporate debt securities and certificates of deposit.

The Company sells its products and services to various companies in the healthcare industry that are located in the United States. We perform ongoing credit evaluations of our customers financial condition and generally require no collateral from customers. An allowance for doubtful accounts is maintained for potentially uncollectible accounts receivable. The Company did not have any single customer representing over 10% of net revenues or accounts receivable during 2016, 2015, or 2014.

Stock Based Compensation

As of December 31, 2016, the Company maintains three stock based compensation plans under which awards are outstanding, which are described in Note 11. The Company accounts for stock based compensation using the fair-value based method for costs related to share-based payments, including stock options and restricted share units. The Company uses the Black Scholes option pricing model for calculating the fair value of option awards issued under its stock based compensation plan. The Company measures compensation cost of restricted share units based on the closing fair market value of the Company s stock on the date of grant. Stock based compensation cost is measured at the grant date, based on the fair value of the award that is ultimately expected to vest, and is recognized as an expense over the requisite service period. The Company recognizes tax benefits from stock based compensation if an excess tax benefit is realized. Excess tax benefits are recorded as an increase to common stock when realized.

HEALTHSTREAM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Newly Issued Accounting Standards

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers (Topic 606)*, which supersedes the revenue recognition requirements in Topic 605, *Revenue Recognition*, and most industry-specific revenue recognition guidance throughout the Industry Topics of the Accounting Standards Codification. The updated guidance states that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance also provides for additional disclosures with respect to revenues and cash flows arising from contracts with customers. The standard will be effective for the first interim period within annual reporting periods beginning after December 15, 2017, and the Company currently anticipates adopting the standard using the modified retrospective approach effective January 1, 2018. The Company is in the process of implementing the standard, and has identified several key provisions that may result in changes to current accounting policies, systems and processes, and internal controls, including but not limited to the following: 1) Determining the relative selling price for software-as-a-service agreements, software licenses, software maintenance, and professional services in order to assign value to the separate performance obligations within a contract. Certain existing right to use arrangements are recognized over time because VSOE cannot be established, but may result in earlier revenue recognition under the new standard. 2) Capitalizing costs to acquire contracts, such as sales commissions, is not a current accounting policy, therefore we expect historical sales commissions, which have been expensed as incurred, will need to be evaluated for capitalization; 3) Ensuring the Company s financial systems can record, calculate, summarize, and report the necessary information required by the standard, which will require additional investments in technology and resources. The Company is not currently able to quantify the financial impact of the Company s adoption of this accounting standard on its future consolidated financial statements, but does anticipate adjustments to retained earnings upon adoption.

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842),* which requires lessees to recognize assets and liabilities for most leases. The recognition, measurement and presentation of expenses and cash flows arising from a lease by a lessee is not expected to significantly change under such guidance; however, the Company is currently reviewing this standard to determine the method of adoption and to assess the impact on its future consolidated financial statements. The standard will be effective for the first interim period within annual reporting periods beginning after December 15, 2018, and early adoption is permitted.

In March 2016, the FASB issued ASU 2016-09, *Compensation Stock Compensation (Topic 718),* which serves to simplify several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. The standard will be effective for the first interim period within annual reporting periods beginning after December 15, 2016, and early adoption is permitted in any interim or annual period. The Company does not expect the adoption will have a material effect on its future consolidated financial statements.

In March 2016, the FASB issued ASU 2016-01, *Financial Instruments Overall (Sub Topic 825-10)*, which addresses certain aspects of the recognition, measurement, presentation, and disclosure of financial instruments. The guidance will, among other things, require equity method investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income. The standard will be effective for the first interim period within annual reporting periods beginning after December 15, 2017, and early adoption is permitted for only limited aspects of such guidance. The Company is currently reviewing this standard to determine the method of adoption and to assess the impact on its future consolidated financial statements.

2. SHAREHOLDERS EQUITY

Common Stock

The Company is authorized to issue up to 75 million shares of common stock. The number of common shares issued and outstanding as of December 31, 2016 and 2015 was approximately 31.7 million and 31.6 million, respectively. The Company issued approximately 3.9 million shares of common stock in connection with an underwritten public offering, which was completed in May 2015, raising approximately $98.0 million of cash.

Preferred Stock

The Company is authorized to issue up to 10 million shares of preferred stock in one or more series, having the relative voting powers, designations, preferences, rights and qualifications, limitations or restrictions, and other terms as the Board of Directors may fix in providing for the issuance of such series, without any vote or action of the shareholders.

HEALTHSTREAM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. EARNINGS PER SHARE

The following table sets forth the computation of basic and diluted earnings per share for the three years ended December 31, 2016 (in thousands, except per share amounts):

	2016	2015	2014
Numerator:			
Net income	$ 3,755	$ 8,621	$ 10,394
Denominator:			
Weighted-average shares outstanding	31,721	30,057	27,570
Effect of dilutive shares	347	379	453
Weighted-average diluted shares	32,068	30,436	28,023
Basic earnings per share	$ 0.12	$ 0.29	$ 0.38
Diluted earnings per share	$ 0.12	$ 0.28	$ 0.37

Potentially dilutive shares representing approximately 38,000, 16,000, and 70,000 shares of common stock for 2016, 2015, and 2014, respectively, were excluded from the calculation of diluted earnings per share because their effect would have been anti-dilutive.

4. MARKETABLE SECURITIES

At December 31, 2016 and 2015, the fair value of marketable securities, which were all classified as available for sale, included the following (in thousands):

	December 31, 2016			
	Adjusted Cost	Unrealized Gains	Unrealized Losses	Fair Value
Level 2:				
Corporate debt securities	$ 44,486	$	$ (50)	$ 44,436
Government-sponsored enterprise debt securities	9,105	1	(2)	9,104
Total	$ 53,591	$ 1	$ (52)	$ 53,540

	December 31, 2015			
	Adjusted Cost	Unrealized Gains	Unrealized Losses	Fair Value
Level 2:				
Certificates of deposit	$ 1,000	$ 0	$ 0	$ 1,000
Corporate debt securities	66,046	0	(70)	65,976
Total	$ 67,046	$ 0	$ (70)	$ 66,976

The carrying amounts of the marketable securities reported in the consolidated balance sheets approximate fair value based on quoted market prices or alternative pricing sources and models utilizing market observable inputs. As of December 31, 2016, the Company does not consider any of its marketable securities to be other than temporarily impaired. During the years ended December 31, 2016 and 2015, the Company did not reclassify any items out of accumulated other comprehensive income to net income. All investments in marketable securities are classified as a current asset on the balance sheet because the underlying securities mature within one year from the balance sheet date.

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HEALTHSTREAM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

5. BUSINESS COMBINATIONS

Morrisey Associates, Inc.

On August 8, 2016, Echo, Inc. (Echo), a wholly owned subsidiary of the Company, acquired all of the outstanding stock of Morrisey Associates, Inc. (MAI), a Chicago, Illinois based company that provides credentialing and privileging software to healthcare organizations. The acquisition of MAI allows the Company to expand its credentialing and privileging product offerings and solutions to healthcare organizations. The consideration paid for MAI consisted of approximately $48.0 million in cash, which the Company funded with cash on hand, and was not subject to any post-closing working capital or similar adjustment. The Company incurred approximately $953,000 in transaction costs, all of which were incurred during the year ended December 31, 2016. The transaction costs were recorded in other general and administrative expenses in the consolidated statements of income. The results of operations for MAI have been included in the Company s consolidated financial statements from the date of acquisition, and are also included in the HealthStream Provider Solutions segment.

A summary of the purchase price is as follows (in thousands):

Cash paid at closing	$ 44,120
Cash held in escrow	3,880
Total consideration paid	$ 48,000

The following table summarizes the fair value of the assets acquired and liabilities assumed as of the date of acquisition (in thousands):

Accounts receivable, net	3,402
Prepaid royalties and other prepaid assets	187
Property and equipment	75
Deferred tax assets	1,507
Goodwill	20,467
Intangible assets	27,400
Accounts payable and accrued liabilities	(1,031)
Deferred revenue	(4,007)
Net assets acquired	$ 48,000

The excess purchase price over the fair values of net tangible and intangible assets has been recorded as goodwill. The fair values of tangible and identifiable intangible assets and deferred revenue are based on management s estimates and assumptions. The fair values of assets acquired and liabilities assumed are based on based on management s estimates and assumptions. The goodwill balance is primarily attributed to the assembled workforce, additional market opportunities from offering MAI s products, and expected synergies from integrating MAI with other products or other combined functional areas within the Company. The goodwill balance is deductible for U.S. income tax purposes. The net tangible assets include deferred revenue, which was adjusted down from a book value at the acquisition date of $8.8 million to an estimated fair value of $4.0 million. The $4.8 million write-down of deferred revenue will result in lower revenues than would have otherwise been recognized for such services.

The following table sets forth the components of identifiable intangible assets and their estimated useful lives as of the acquisition date (in thousands):

	Fair value	**Useful life**
Customer relationships	$ 21,400	13 years
Developed technology	5,400	5 years
Trade name	600	6 years
Total intangible assets subject to amortization	$ 27,400	

HEALTHSTREAM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

5. BUSINESS COMBINATIONS (continued)

The amounts of revenue and operating loss of MAI included in the Company s consolidated statement of income from the date of acquisition of August 8, 2016 to the period ending December 31, 2016 are as follows (in thousands):

Total revenues	$ 2,581
Operating loss	$ (2,358)

The following unaudited pro forma financial information summarizes the combined results of operations of the Company and MAI, which was significant for purposes of the unaudited pro forma financial information disclosure, as though the companies were combined as of January 1, 2015 (in thousands, except per share data):

	Year Ended December 31,	
	2016	**2015**
Total revenues	$ 236,205	$ 218,042
Net income	$ 6,610	$ 7,533
Basic earnings per share	$ 0.21	$ 0.25
Diluted earnings per share	$ 0.21	$ 0.25

These unaudited pro forma combined results of operations include certain adjustments arising from the acquisition such as adjustment for amortization of intangible assets, depreciation of property and equipment, and fair value adjustments of acquired deferred revenue balances. The unaudited pro forma combined results of operations is for informational purposes only and is not indicative of what the Company s results of operations would have been had the transaction occurred at the beginning of the period presented or to project the Company s results of operations in any future period.

The unaudited pro forma financial information for the years ended December 31, 2016 and 2015 combines the historical results of the Company and MAI for the years ended December 31, 2016 and 2015 and the pro forma adjustments listed above.

HealthLine Systems

On March 16, 2015, the Company acquired all of the membership interests of HealthLine Systems, LLC (HLS), a San Diego, California based company that specializes in credentialing, privileging, call center, and quality management solutions for the healthcare industry. The acquisition of HLS enabled the Company to provide a comprehensive solution set for healthcare provider credentialing, privileging, enrollment, referral, onboarding, and analytics in support of HealthStream s approach to talent management for healthcare organizations. The consideration paid for HLS consisted of approximately $90.5 million in cash (taking into account an estimated closing working capital adjustment and the payment of an incremental tax indemnification claim by the Company as noted below). The Company incurred approximately $1.3 million in transaction costs associated with the acquisition, of which $965,000 were incurred during the year ended December 31, 2015 and $329,000 were incurred during the year ended December 31, 2014. The transaction costs were recorded in other general and administrative expenses in the consolidated statements of income for such periods. The results of operations for HLS have been included in the Company s consolidated financial statements from the date of acquisition, and are also included in the HealthStream Provider Solutions segment.

A summary of the purchase price is as follows (in thousands):

Cash paid	$ 89,850
Cash held in escrow	679
Total consideration paid	$ 90,529

The following table summarizes the fair value of the assets acquired and liabilities assumed as of the date of acquisition (in thousands):

Cash	$ 54
Accounts receivable, net	3,052
Prepaid assets	546
Property and equipment	200
Deferred tax assets	2,523
Goodwill	43,798
Intangible assets	47,200
Accounts payable and accrued liabilities	(1,085)
Deferred revenue	(5,979)
Net assets acquired	$ 90,309

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HEALTHSTREAM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

5. BUSINESS COMBINATIONS (continued)

The total consideration paid does not equal the fair value of assets acquired and liabilities assumed due to the post measurement period adjustment discussed below. The excess of purchase price over the fair values of net tangible and intangible assets has been recorded as goodwill. The fair values of tangible and identifiable intangible assets, deferred tax assets, deferred revenue, and other liabilities are based on management s estimates and assumptions. Included in the assets and liabilities assumed is an estimated indemnification asset of $300,000 and a contingent liability of $700,000, both of which are associated with tax liabilities. The contingent liability is measured based on management s estimate of a range of probable outcomes. The goodwill balance is primarily attributed to the assembled workforce, additional market opportunities from offering HLS s products, and expected synergies from integrating HLS with other products or other combined functional areas within the Company. During the three months ended March 31, 2016, the Company received notice of an indemnification claim from the former owners of HLS pursuant to the terms of the membership interest purchase agreement. The terms of such agreement require the Company to indemnify such owners for incremental taxes incurred as the result of the structure of the acquisition, which had favorable tax aspects to the Company. The Company recorded a measurement period adjustment in relation to the claim that increased goodwill by approximately $2.2 million during the three months ended March 31, 2016. The additional goodwill is deductible for U.S. income tax purposes. The goodwill balance excluding such measurement period adjustment is also deductible for U.S. income tax purposes. During the three months ended September 30, 2016, the Company agreed to settle this indemnification claim for approximately $2.4 million in respect of such tax indemnification provision in the membership interest purchase agreement, a difference of approximately $200,000 from the $2.2 million measurement period adjustment. The Company surpassed the one year measurement period as of the period ended March 31, 2016; accordingly, in accordance with requisite accounting guidance, the $200,000 difference has been reflected as a charge against net income for the year ended December 31, 2016. The net tangible assets include deferred revenue, which was adjusted down from a book value at the acquisition date of $15.0 million to an estimated fair value of $6.0 million. The $9.0 million write-down of deferred revenue will result in lower revenues than would have otherwise been recognized for such services.

The following table sets forth the components of identifiable intangible assets and their estimated useful lives as of the acquisition date (in thousands):

	Fair value	Useful life
Customer relationships	$ 42,600	13 years
Developed technology	3,700	5 years
Trade names	900	6 years
Total intangible assets subject to amortization	$ 47,200	

The amounts of revenue and operating income (loss) of HLS included in the Company s consolidated statement of income from the date of acquisition of March 16, 2015 to the period ending December 31, 2015 are as follows (in thousands):

Total revenues	$ 8,543
Operating loss	$ (2,541)

The following unaudited pro forma financial information summarizes the combined results of operations of the Company and HLS, which was significant for purposes of the unaudited pro forma financial information disclosure, as though the companies were combined as of January 1, 2015 (in thousands, except per share data):

	Year Ended December 31,	
	2016	**2015**
Total revenues	$ 227,834	$ 219,108
Net income	$ 4,924	$ 13,551
Basic earnings per share	$ 0.16	$ 0.45
Diluted earnings per share	$ 0.15	$ 0.44

These unaudited pro forma combined results of operations include certain adjustments arising from the acquisition such as adjustment for amortization of intangible assets, depreciation of property and equipment, fair value adjustments of acquired deferred revenue balances, and interest expense associated with borrowings under a revolving credit facility by the Company to partially fund the acquisition. The unaudited pro forma combined results of operations is for informational purposes only and is not indicative of what the Company s results of operations would have been had the transaction occurred at the beginning of the period presented or to project the Company s results of operations in any future period.

The unaudited pro forma financial information for the years ended December 31, 2016 and 2015 combines the historical results of the Company and HLS for the years ended December 31, 2016 and 2015 and the pro forma adjustments listed above.

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HEALTHSTREAM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

5. BUSINESS COMBINATIONS (continued)

Health Care Compliance Strategies

On March 3, 2014, the Company acquired all of the stock of Health Care Compliance Strategies, Inc. (HCCS), a Jericho, New York based company that specializes in healthcare compliance solutions and services. The Company acquired HCCS to further advance its suite of workforce development solutions, including its offering of compliance solutions. The consideration paid for HCCS consisted of approximately $12.8 million in cash (taking into account a post-closing working capital adjustment) and 81,614 shares of our common stock. The Company made an additional payment of $750,000 during the second quarter of 2015, upon the achievement of certain performance milestones within one year post-closing. The Company incurred approximately $515,000 in transaction costs associated with the acquisition, of which $365,000 were incurred during the year ended December 31, 2014 and $150,000 were incurred during the year ended December 31, 2013. The transaction costs were recorded under the caption other general and administrative in the consolidated statements of income. In allocating the purchase price, the Company recorded approximately $6.2 million of goodwill, $8.4 million of identifiable intangible assets, $2.6 million of tangible assets, $625,000 of deferred tax assets, and $2.7 million of liabilities. Included in the recorded liabilities was an accrual for contingent consideration of approximately $600,000. The goodwill balance is primarily attributed to assembled workforce, additional market opportunities of HCCS s compliance solutions, and expected synergies from integrating HCCS s products into our platform. The goodwill balance is deductible for U.S. income tax purposes. The net tangible assets include deferred revenue, which was adjusted down from a book value at the acquisition date of $3.2 million to an estimated fair value of $1.7 million. The $1.5 million write-down of deferred revenue resulted in lower revenues than would have otherwise been recognized for such services. The results of operations for HCCS have been included in the Company s consolidated financial statements from the date of acquisition, and are also included in the HealthStream Workforce Development Solutions segment.

Other Business Combinations

On June 30, 2016, the Company acquired all of the stock of Performance Management Services, Inc. (PMSI), a Company based in Tustin, California focused on competency-based performance development for nurses, for $4.0 million in cash and up to an additional $500,000 of contingent consideration. The acquisition, including associated transaction costs, is not considered material to the Company s financial statements. The Company accounted for the acquisition as a business combination and has allocated the purchase consideration based on management s estimates of fair value. The results of operations for PMSI are included in the Company s consolidated financial statements from the date of acquisition and are included in the HealthStream Workforce Solutions segment.

On July 25, 2016, the Company purchased all of the outstanding stock of Nursing Registry Consultants Corporation (Nurse Competency) not previously held by the Company for approximately $1.0 million in cash and up to an additional $75,000 in contingent consideration. Nurse Competency provides SaaS-based clinical assessment and testing products to the healthcare industry. The Company previously held a 32% minority equity interest in Nurse Competency and had accounted for such interest as an equity method investment. The fair value of the minority equity interest as of the July 25, 2016 acquisition date was approximately $484,000 and was determined in accordance with the fair value of the controlling interest acquired with consideration given to acquisition premiums, where applicable.

The Company recorded a gain of approximately $225,000 to account for the difference between the noted acquisition date fair value of the minority equity interest and the carrying value as of such date. The gain is included in other income (expense), net in the consolidated statement of income for the year ended December 31, 2016. The Company accounted for the acquisition as a business combination and has allocated the purchase consideration based on management s estimates of fair value. The results of operations for Nurse Competency are included in the Company s consolidated financial statements from the date of acquisition and are included in the HealthStream Workforce Solutions segment.

HEALTHSTREAM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

6. PROPERTY AND EQUIPMENT

Property and equipment consist of the following:

	December 31, 2016	December 31, 2015
Equipment	$ 20,885	$ 23,057
Leasehold improvements	5,025	4,435
Furniture and fixtures	4,862	4,338
Gross property and equipment	30,772	31,830
Accumulated depreciation and amortization	(20,527)	(19,359)
Property and equipment, net	$ 10,245	$ 12,471

Depreciation of property and equipment totaled approximately $6.8 million and $5.3 million for the years ended December 31, 2016 and 2015, respectively.

7. GOODWILL

The changes in the carrying amount of goodwill for the years ended December 31, 2016 and 2015 are as follows (in thousands):

	Workforce	Patient Experience	Provider	Total
Balance at January 1, 2016	$ 12,336	$ 24,154	$ 46,583	$ 83,073
Acquisition of HealthLine Systems, LLC.			2,180	2,180
Acquisition of Morrisey Associates, Inc.			20,467	20,467
Other business combinations	4,045			4,045
Balance at December 31, 2016	$ 16,381	$ 24,154	$ 69,230	$ 109,765

	Workforce	Patient Experience	Provider	Total
Balance at January 1, 2015	$ 12,336	$ 24,154	$ 5,424	$ 41,914
Acquisition of HealthLine Systems, LLC			41,618	41,618

Disposal of long lived assets			(459)	(459)
Balance at December 31, 2015	$ 12,336	$ 24,154	$ 46,583	$ 83,073

During the three months ended March 31, 2016, the Company recorded approximately $2.2 million of additional goodwill in relation to the March 2015 acquisition of HealthLine Systems, LLC. Such amount relates to the measurement period adjustment previously mentioned in Note 5 under the caption *HealthLine Systems.* During the quarter ended December 31, 2015, the Company disposed of certain long lived assets meeting the definition of a business. Accordingly, we have allocated approximately $459,000 of reporting unit goodwill to this disposition of assets pursuant to ASC 350, *Intangibles Goodwill and other.*

HEALTHSTREAM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

8. INTANGIBLE ASSETS

Intangible assets other than goodwill are considered to have finite useful lives. Customer related intangibles are amortized over their estimated useful lives ranging from five to thirteen years. Other intangible assets include non-competition agreements, technology and patents, and trade names, and are being amortized over periods ranging from three to nine years. During the quarter ended December 31, 2015, the Company retired approximately $10.7 million of fully amortized identifiable intangible assets. Gross amounts and related accumulated amortization presented below as of December 31, 2015 are reflective of such retirements. Additionally, amounts presented below as of December 31, 2016 and December 31, 2015 are inclusive of identifiable intangible assets recorded in relation to our acquisitions of Morrisey Associates, Inc. and HealthLine Systems, LLC, as well as other business combinations (see Note 5 Business Combinations). Amortization of intangible assets was approximately $7.8 million and $5.6 million for the years ended December 31, 2016 and 2015, respectively.

Identifiable intangible assets are comprised of the following (in thousands):

	As of December 31, 2016			As of December 31, 2015		
	Gross Amount	Accumulated Amortization	Net	Gross Amount	Accumulated Amortization	Net
Customer related	$ 77,985	$ (11,539)	$ 66,446	$ 55,571	$ (6,068)	$ 49,503
Other	16,824	(4,906)	11,918	9,080	(2,617)	6,463
Total	$ 94,809	$ (16,445)	$ 78,364	$ 64,651	$ (8,685)	$ 55,966

The expected future annual amortization expense for the years ending December 31, is as follows (in thousands):

2017	$ 9,549
2018	9,437
2019	8,792
2020	8,139
2021	7,356
Thereafter	35,091
Total	$ 78,364

9. BUSINESS SEGMENTS

The Company provides services to healthcare organizations and other members within the healthcare industry. The Company s services are focused on the delivery of workforce development products and services (HealthStream

Workforce Solutions), survey and research services (HealthStream Patient Experience Solutions), and provider credentialing, privileging, call center and enrollment products and services (HealthStream Provider Solutions).

The Company measures segment performance based on operating income before income taxes and prior to the allocation of certain corporate overhead expenses, interest income, interest expense, gains and losses from equity investments, and depreciation. The Unallocated component below includes corporate functions, such as accounting, human resources, legal, investor relations, administrative and executive personnel, depreciation, a portion of amortization, and certain other expenses, which are not currently allocated in measuring segment performance. The following is the Company s business segment information as of and for the years ended December 31, 2016, 2015 and 2014 (in thousands).

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HEALTHSTREAM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

9. BUSINESS SEGMENTS (continued)

Revenues, net:	2016	2015	2014
Workforce	$ 168,040	$ 161,289	$ 134,242
Patient Experience	33,850	34,193	31,901
Provider	24,084	13,520	4,547
Total revenues, net	$ 225,974	$ 209,002	$ 170,690

Operating income:	2016	2015	2014
Workforce	$ 37,329	$ 39,986	$ 35,374
Patient Experience	(522)	1,548	810
Provider	(2,443)	(2,559)	826
Unallocated	(28,797)	(25,418)	(20,635)
Total operating income	$ 5,567	$ 13,557	$ 16,375

	Assets *			Purchases of long-lived assets			Depreciation and amortization		
	2016	2015	2014	2016	2015	2014	2016	2015	2014
Workforce	$ 96,323	$ 82,375	$ 81,116	$ 9,266	$ 11,403	$ 7,179	$ 8,243	$ 6,693	$ 4,813
Patient Experience	35,988	34,902	34,536	1,123	2,007	1,277	1,144	1,061	1,272
Provider	155,011	100,948	10,976	2,026	332	200	6,061	3,986	683
Unallocated	108,678	161,344	130,634	2,135	1,617	1,546	6,759	5,257	4,163
Total	$ 396,000	$ 379,569	$ 257,262	$ 14,550	$ 15,359	$ 10,202	$ 22,207	$ 16,997	$ 10,931

* Segment assets include accounts and unbilled receivables, prepaid royalties, prepaid and other current assets, other assets, capitalized software development, certain property and equipment, and intangible assets. Cash and cash equivalents and marketable securities are not allocated to individual segments, and are included within Unallocated. A significant portion of property and equipment assets are included within Unallocated.

10. INCOME TAXES

The provision (benefit) for income taxes is comprised of the following (in thousands):

	Year Ended December 31,		
	2016	2015	2014
Current federal	$ (271)	$ 3,608	$ 3,198
Current state	877	1,098	1,605
Deferred federal	1,489	501	1,092
Deferred state	298	(109)	232
Provision for income taxes	$ 2,393	$ 5,098	$ 6,127

A reconciliation of income taxes at the statutory federal income tax rate to the provision for income taxes included in the accompanying consolidated statements of income is as follows (in thousands):

	Year Ended December 31,		
	2016	2015	2014
Federal tax provision at the statutory rate	$ 2,152	$ 4,802	$ 5,782
State income tax provision, net of federal benefit	539	673	1,350
Tax credits	(560)	(425)	(1,160)
Change in state valuation allowance	308	(8)	37
Other	(46)	56	118
Provision for income taxes	$ 2,393	$ 5,098	$ 6,127

Management periodically assesses the realizability of its deferred tax assets, and to the extent that a recovery is not likely, a valuation allowance is established to reduce the deferred tax asset to the amount estimated to be recoverable. At December 31, 2016, a valuation allowance of $654,000 exists.

HEALTHSTREAM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

10. INCOME TAXES (continued)

As of December 31, 2016, the Company had federal and state net operating loss carryforwards of $478,000 and $17.6 million, respectively. These loss carryforwards will expire in years 2017 through 2026. The Company is subject to income taxation at the federal and various state levels. The Company is subject to U.S. federal tax examinations for tax years 2015 through 2016. Loss carryforwards and credit carryforwards generated or utilized in years earlier than 2015 are also subject to examination and adjustment. The Company has completed examinations with the Internal Revenue Service for tax years 2013 and 2014. The Company has research and development tax credit carryforwards of $2.7 million that expire in varying amounts through 2036. As of December 31, 2016, the Company had alternative minimum tax credit carryforwards of $837,000 that are available to offset future regular tax liabilities and they do not expire.

A reconciliation of the beginning and ending liability for gross unrecognized tax benefits at December 31, 2016 and 2015, are as follows (in thousands):

	December 31,	
	2016	2015
Balance at beginning of year	$ 658	$ 2,168
Additions for tax positions in the current year	64	351
Reductions for tax positions of prior years	(325)	(1,861)
Balance at end of year	$ 397	$ 658

The Company recognized approximately $18,000 and $14,000 for interest and penalties related to unrecognized tax benefits within the provision for income taxes during the years ended December 31, 2016 and 2015, respectively. Unrecognized tax benefits included tax positions of approximately $350,000 and $308,000 at December 31, 2016 and 2015, respectively, that if recognized would impact the Company s effective tax rate. The reduction for tax positions of prior years reflected in the table above as of December 31, 2016 relates to an amended return filed with the IRS. The Company estimates that it is reasonably possible the liability for unrecognized tax benefits could decrease up to $46,000 within the next 12 months.

Deferred federal and state income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of deferred tax assets and deferred tax liabilities are as follows (in thousands):

	December 31,	
	2016	2015
Deferred tax assets:		

Allowance for doubtful accounts	$ 332	$ 122
Accrued liabilities	1,275	2,062
Tax credits	1,397	816
Stock based compensation	1,171	1,107
Deferred revenue	1,818	1,563
Depreciation	1,119	348
Basis difference on investments	316	80
Net operating loss carryforwards	743	407
Total deferred tax assets	8,171	6,505
Less: Valuation allowance	(654)	(346)
Deferred tax assets, net of valuation allowance	7,517	6,159
Deferred tax liabilities:		
Deductible goodwill	3,267	2,646
Nondeductible intangible assets	2,523	1,806
Prepaid assets	1,894	1,911
Capitalized software development	5,801	4,559
Total deferred tax liabilities	13,485	10,922
Net deferred tax liabilities	$ (5,968)	$ (4,763)

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HEALTHSTREAM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

11. STOCK BASED COMPENSATION

Stock Incentive Plans

The Company s 2016 Omnibus Incentive Plan (2016 Plan), 2010 Stock Incentive Plan (2010 Plan) and 2000 Stock Incentive Plan (2000 Plan; collectively, the 2016 Plan, the 2010 Plan and the 2000 Plan referred to as the Plan) authorize the grant of options, restricted share units (RSU), or other forms of stock based compensation to employees, officers, directors and others, and such grants must be approved by the Compensation Committee of the Board of Directors. Options granted under the Plan have terms of no more than ten years, with certain restrictions. The Plan allows the Compensation Committee of the Board of Directors to determine the vesting period and parameters of each grant. The vesting period of the options and RSUs granted has historically ranged from immediate vesting to annual vesting up to four years, generally beginning one year after the grant date. As of December 31, 2016, approximately 1.5 million shares of unissued common stock remained reserved for future stock incentive grants under the 2016 Plan. The Company issues new shares of common stock when options are exercised or when RSUs become vested.

Stock Option Activity

A summary of activity and various other information relative to stock options for the year ended December 31, 2016 is presented in the tables below (in thousands, except exercise price).

	Common Shares	Weighted-Average Exercise Price	Aggregate Intrinsic Value
Outstanding at beginning of period	520	$ 6.41	
Granted			
Exercised	(44)	3.33	
Expired			
Forfeited			
Outstanding at end of period	476	$ 6.74	$ 8,716
Exercisable at end of period.	476	$ 6.74	$ 8,716

The aggregate intrinsic value for stock options in the table above represents the total difference between the Company s closing stock price on December 30, 2016 (the last trading day of the year) of $25.05 per share and the option exercise price, multiplied by the number of in-the-money options as of December 31, 2016. The weighted average remaining contractual term of options outstanding at December 31, 2016 was 1.6 years. Options exercisable at December 31, 2016 have a weighted average remaining contractual term of 1.6 years.

Other information relative to option activity during the three years ended December 31, 2016 is as follows (in thousands):

	2016	2015	2014
Total grant date fair value of stock options vested	$	$ 232	$ 630
Total intrinsic value of stock options exercised	$ 820	$ 1,662	$ 5,912
Cash proceeds from exercise of stock options	$ 146	$ 328	$ 1,094

Restricted Share Unit Activity

A summary of activity relative to RSUs for the year ended December 31, 2016 is as follows (in thousands, except weighted average grant date fair value):

	Number of RSU s	Weighted-Average Grant Date Fair Value	Aggregate Intrinsic Value
Outstanding at beginning of period	218	$ 25.21	
Granted	116	20.72	
Vested	(74)	24.54	
Forfeited	(7)	24.50	
Outstanding at end of period	253	$ 23.36	$ 6,331

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HEALTHSTREAM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

11. STOCK BASED COMPENSATION (continued)

The aggregate fair value of RSU awards that vested in 2016 and 2015, as of the respective vesting dates, was approximately $1.5 million and $1.4 million, respectively. A portion of RSUs that vested in 2016 and 2015 were net-share settled such that the Company withheld shares with value equivalent to the employees minimum statutory obligation for the applicable income and other employment taxes, and remitted the cash to the appropriate taxing authorities. The total shares withheld for RSUs during 2016 and 2015 were 15,373 and 8,922, respectively, and were based on the value of the RSUs on their respective settlement dates as determined by the Company s closing stock price. Total payments related to RSUs for the employees tax obligations to taxing authorities were approximately $316,000 in 2016 and $230,000 in 2015, and are reflected as a financing activity within the consolidated statements of cash flows. These net-share settlements had the effect of share repurchases by the Company as they reduced and retired the number of shares that would have otherwise been issued as a result of the vesting and did not represent an expense to the Company.

Stock Based Compensation

Total stock based compensation expense, which is recorded in our consolidated statements of income, recorded for the years ended December 31, is as follows (in thousands):

	Years Ended December 31,		
	2016	**2015**	**2014**
Cost of revenues (excluding depreciation and amortization)	$ 144	$ 824	$ 86
Product development	178	569	201
Sales and marketing	239	547	224
Other general and administrative	1,407	1,340	1,114
Total stock based compensation expense	$ 1,968	$ 3,280	$ 1,625

The Company amortizes the fair value of all stock based awards, net of estimated forfeitures, on a straight-line basis over the requisite service period, which generally is the vesting period. As of December 31, 2016, total unrecognized compensation expense related to non-vested stock options and RSUs was approximately $3.1 million, net of estimated forfeitures, with a weighted average expense recognition period remaining of 2.4 years. The Company realized approximately $217,000 of excess tax benefits related to stock based awards during the year ended December 31, 2016, which was recorded as an increase to common stock.

Stock based compensation cost for RSUs is measured based on the closing fair market value of the Company s stock on the date of grant. Stock based compensation cost for stock options is estimated at the grant date based on the fair value calculated using the Black-Scholes method. The Company did not grant any stock options during 2016, 2015, or 2014.

Stock Awards

During June 2015, the Company s Chief Executive Officer (CEO), Robert A. Frist, Jr., entered into an agreement with the Company pursuant to which he contributed 54,241 of his personally owned shares of HealthStream, Inc. common stock to the Company, without any consideration paid to him. In connection with this contribution, the Company approved the grant of 49,310 shares of HealthStream, Inc. common stock to over 600 employees who were not otherwise eligible to receive equity awards and had at least one year of service with the Company. The Company recognized approximately $1.5 million of stock based compensation expense for these stock awards during the three months ended June 30, 2015 based on the closing fair market value of the Company s stock on the date of the Company s approval of these grants. In connection with these equity awards, effective in the second quarter of 2015, the Company withheld shares with value equivalent to the employees minimum statutory obligation for the applicable income and other employment taxes, and remitted the cash to the appropriate taxing authorities. The total shares withheld were 17,279, and were based on the value of the stock awards on the date of the Company s approval of these grants, as determined by the Company s closing stock price on that date. Total payments related to the employees tax obligations to taxing authorities for these stock awards were approximately $526,000, and are reflected as a financing activity within the consolidated statements of cash flows for the year ended December 31, 2015. These share withholdings had the effect of share repurchases by the Company as they reduced and retired the number of shares otherwise issuable as a result of the stock awards and did not represent an expense to the Company.

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HEALTHSTREAM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

12. EMPLOYEE BENEFIT PLAN

401(k) Plan

The Company has a defined-contribution employee benefit plan (401(k) Plan) incorporating provisions of Section 401(k) of the Internal Revenue Code. Employees must have attained the age of 21 and have completed thirty days of service to be eligible to participate in the 401(k) Plan. Under the provisions of the 401(k) Plan, a plan member may make contributions, on a tax-deferred basis, subject to IRS limitations. The Company elected to provide eligible employees with matching contributions totaling approximately $391,000 and $645,000 for the years ended December 31, 2016 and 2015, respectively.

13. DEBT

At December 31, 2016 and 2015, the Company had no debt outstanding.

Revolving Credit Facility

The Company maintains a Loan Agreement (the Revolving Credit Facility) with SunTrust Bank (SunTrust) in the aggregate principal amount of $50.0 million, which matures on November 24, 2017. Under the Revolving Credit Facility, the Company may borrow up to $50.0 million, which includes a $5.0 million swing line subfacility and a $5.0 million letter of credit subfacility, as well as an accordion feature that allows the Company to increase the Revolving Credit Facility by a total of up to $25.0 million, subject to securing additional commitments from existing lenders or new lending institutions. The obligations under the Revolving Credit Facility are guaranteed by each of the Company s subsidiaries. At the Company s election, the borrowings under the Revolving Credit Facility bear interest at either (1) a rate per annum equal to the highest of SunTrust s prime rate or 0.5% in excess of the Federal Funds Rate or 1.0% in excess of one-month LIBOR (the Base Rate), plus an applicable margin, or (2) the one, two, three, or six-month per annum LIBOR for deposits in the applicable currency (the Eurocurrency Rate), as selected by the Company, plus an applicable margin. The applicable margin for Eurocurrency Rate loans depends on the Company s funded debt leverage ratio and varies from 1.50% to 2.00%. The applicable margin for Base Rate loans depends on the Company s funded debt leverage ratio and varies from 0.50% to 1.50%. Commitment fees and letter of credit fees are also payable under the Revolving Credit Facility. Principal is payable in full at maturity on November 24, 2017, and there are no scheduled principal payments prior to maturity. The Company is required to pay a commitment fee ranging between 20 and 30 basis points per annum of the average daily unused portion of the Revolving Credit Facility, depending on the Company s funded debt leverage ratio.

The purpose of the Revolving Credit Facility is for general working capital needs, permitted acquisitions (as defined in the Loan Agreement), and for stock repurchase and/or redemption transactions that the Company may authorize.

The Revolving Credit Facility contains certain covenants that, among other things, restrict additional indebtedness, liens and encumbrances, changes to the character of the Company s business, acquisitions, asset dispositions, mergers and consolidations, sale or discount of receivables, creation or acquisitions of additional subsidiaries, and other matters customarily restricted in such agreements.

In addition, the Revolving Credit Facility requires the Company to meet certain financial tests, including, without limitation:

- a funded debt leverage ratio (consolidated debt/consolidated EBITDA) of not greater than 3.0 to 1.0; and
- an interest coverage ratio (consolidated EBITDA/consolidated interest expense) of not less than 3.0 to 1.0.

As of December 31, 2016, the Company was in material compliance with all covenants. There were no balances outstanding on the Revolving Credit Facility as of December 31, 2016 and there were no borrowings under the Revolving Credit Facility during the year ended December 31, 2016. During the three months ended March 31, 2015, the Company borrowed approximately $28.0 million under the Revolving Credit Facility. During the three months ended June 30, 2015, the Company repaid approximately $28.0 million of balances previously outstanding under the Revolving Credit Facility from proceeds received in the Company s public offering of 3,869,750 shares which closed on May 28, 2015.

HEALTHSTREAM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

14. LEASES

The Company has non-cancellable operating leases primarily for office space, hosting facilities, and office equipment. Some lease agreements contain provisions for escalating rent payments over the initial terms of the lease. The Company accounts for these leases by recognizing rent expense on a straight-line basis and adjusting the deferred rent expense liability for the difference between the straight-line rent expense and the amount of rent paid. The terms of the lease agreements generally provide the Company the option to renew. The Company also leases certain office equipment under operating leases. Total rent expense under all operating leases was approximately $5.6 million, $4.3 million, and $3.1 million, for the years ended December 31, 2016, 2015, and 2014, respectively.

Future rental payment commitments at December 31, 2016 under non-cancelable operating leases, with initial terms of one year or more, are as follows (in thousands):

2017	$ 5,044
2018	4,034
2019	2,208
2020	1,027
2021	826
Thereafter	2,748
Total minimum lease payments	$ 15,887

The Company subleases certain of its office space included above under non-cancellable leases and is due to receive future minimum rental payments of approximately $157,000 and $148,000 for the years ended December 31, 2017 and December 31, 2018, respectively.

15. COLLABORATIVE ARRANGEMENT

The Company participates in a collaborative arrangement, SimVentures™, with Laerdal Medical A/S (Laerdal Medical). The Company receives 50 percent of the profits or losses generated from this collaborative arrangement. The parties did not form a separate legal entity as part of the collaborative arrangement; therefore, the Company accounts for SimVentures as a collaborative arrangement in accordance with applicable accounting guidance. For the year ended December 31, 2016, the Company recorded approximately $2.7 million of revenues and $1.4 million of expenses related to the collaborative arrangement. For the year ended December 31, 2015, the Company recorded approximately $2.2 million of revenues and $1.8 million of expenses related to the collaborative arrangement.

16. LITIGATION

In connection with its business, the Company is from time to time involved in various legal actions. The litigation process is inherently uncertain and it is possible that the resolution of such matters might have a material adverse effect upon the financial condition and/or results of operations of the Company. However, in the opinion of the Company s management, matters currently pending or threatened against the Company are not expected to have a material adverse effect on the financial position or results of operations of the Company.

17. RELATED PARTY TRANSACTIONS

During the three months ended June 30, 2015, the Company s CEO, Robert A. Frist, Jr., entered into an agreement with the Company pursuant to which he contributed 54,241 of his personally owned shares of HealthStream, Inc. common stock to the Company, without any consideration paid to him. In connection with this contribution, the Company approved the grant of 49,310 shares of common stock to over 600 employees, with a fair market value of approximately $1.5 million. Mr. Frist contributed 4,931 of the contributed shares noted above to take into account the estimated Company costs, such as administrative expenses and employer payroll taxes associated with the grants (See Note 11).

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

None.

Item 9A. *Controls and Procedures*

Evaluation of Disclosure Controls and Procedures

HealthStream s chief executive officer and principal financial officer have reviewed and evaluated the effectiveness of the Company s disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) promulgated under the Securities Exchange Act of 1934 (the Exchange Act)) as of December 31, 2016. Based on that evaluation, the chief executive officer and principal financial officer have concluded that HealthStream s disclosure controls and procedures were effective to ensure that the information required to be disclosed by the Company in the reports the Company files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission s rules and forms, and the information required to be disclosed in the reports the Company files or submits under the Exchange Act was accumulated and communicated to the Company s management, including its principal executive and principal financial officer, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

Management s Annual Report On Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act, and for assessing the effectiveness of internal control over financial reporting. The Company s internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP. The Company s internal control over financial reporting includes those policies and procedures that: (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Company s assets that could have a material effect on the financial statements.

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

Management assessed the effectiveness of the Company s internal control over financial reporting as of December 31, 2016. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in Internal Control-Integrated Framework (2013 Framework). Management s assessment included an evaluation of the design of our internal control over financial reporting and testing of the operational effectiveness of our internal control over financial reporting. Management believes that, as of December 31, 2016, the Company s internal control over financial reporting was effective based on those criteria. The Company s independent registered public accounting firm, Ernst & Young LLP, has issued an audit report on the Company s internal control over financial reporting, which appears in Item 8 of this Annual Report on Form 10-K.

Changes in Internal Control Over Financial Reporting

There were no changes in HealthStream s internal control over financial reporting that occurred during the fourth quarter of 2016 that have materially affected, or that are reasonably likely to materially affect, HealthStream s internal control over financial reporting.

Item 9B. ***Other Information***

None.

PART III

Item 10. ***Directors, Executive Officers and Corporate Governance***

Information as to directors of the Company and corporate governance is incorporated by reference from the information to be contained in our proxy statement for the 2017 Annual Meeting of Shareholders (2017 Proxy Statement) that we will file with the Securities and Exchange Commission within 120 days of the end of the fiscal year to which this report relates. Pursuant to General Instruction G(3), certain information concerning executive officers of the Company is included in Part I of this Form 10-K, under the caption Executive Officers of the Registrant.

Item 11. ***Executive Compensation***

Incorporated by reference from the information to be contained in the Company s 2017 Proxy Statement.

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

Incorporated by reference from the information to be contained in the Company s 2017 Proxy Statement.

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

Incorporated by reference from the information to be contained in the Company s 2017 Proxy Statement.

Item 14. ***Principal Accounting Fees and Services***

Incorporated by reference from the information to be contained in the Company s 2017 Proxy Statement.

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PART IV

Item 15. *Exhibits, Financial Statement Schedules*

(a)(1) Financial Statements

Reference is made to the financial statements included in Item 8 to this Report on Form 10-K.

(a)(2) Financial Statement Schedules

All schedules are omitted because they are not applicable or the required information is shown in the Consolidated Financial Statements or the notes thereto.

(a)(3) Exhibits

Number	Description
2.1(1)	Membership Interest Purchase Agreement, dated as of February 12, 2015, between HealthStream, Inc., Littrell Holdings, Inc., HealthLine Systems, Inc., the Shareholders of HealthLine Systems, Inc., and Dan Littrell in his individual capacity and as the Shareholders Representative.
2.2(2)	Stock Purchase Agreement, by and between Echo, Inc. and Morrisey Holdings, Inc., dated August 8, 2016.
3.1*	Form of Fourth Amended and Restated Charter of HealthStream, Inc.
3.2(8)*	Form of Second Amended and Restated Bylaws of HealthStream, Inc.
4.1*	Form of certificate representing the common stock, no par value per share, of HealthStream, Inc.
4.2*	Reference is made to Exhibits 3.1 and 3.2.
10.1^*	2000 Stock Incentive Plan, effective as of April 10, 2000
10.2^(6)	2010 Stock Incentive Plan, effective as of May 27, 2010
10.3^*	Form of Indemnification Agreement
10.4^(3)	Executive Employment Agreement, dated July 21, 2005, between HealthStream, Inc. and Robert A. Frist, Jr.
10.5^(4)	Form of HealthStream, Inc. Non-Qualified Stock Option Agreement (Employees) under 2010 Stock Incentive Plan
10.6^(4)	Form of HealthStream, Inc. Incentive Stock Option Agreement (Employees) under 2010 Stock Incentive Plan
10.7^(4)	Form of HealthStream, Inc. Non-Qualified Stock Option Agreement (Directors) under 2010 Stock Incentive Plan
10.8^(5)	Form of HealthStream, Inc. Restricted Share Unit Agreement (Officers) under 2010 Stock Incentive Plan
10.9^(5)	

	Form of HealthStream, Inc. Restricted Share Unit Agreement (Non-Employee Director) under 2010 Stock Incentive Plan
10.10(7)	Revolving Credit Agreement, dated November 24, 2014, by and among HealthStream, Inc., the several banks and other financial institutions and lenders from time to time party thereto and SunTrust Bank, as administrative agent, issuing bank, and swingline lender
10.11^	Summary of Director and Executive Officer Compensation
10.12^(9)	HealthStream, Inc. 2015 Cash Incentive Bonus Plan
10.13(9)	Contribution Agreement, dated as of June 30, 2015, between HealthStream, Inc. and Robert A. Frist, Jr.
10.14^(10)	Letter Agreement, dated as of September 24, 2015, between HealthStream, Inc. and Michael Sousa.
10.15^(10)	Form of HealthStream, Inc. Restricted Share Unit Agreement (Performance) under 2010 Stock Incentive Plan between HealthStream, Inc. and Michael Sousa.
10.16^(10)	Form of HealthStream, Inc. Restricted Share Unit Agreement (Cumulative) under 2010 Stock Incentive Plan between HealthStream, Inc. and Michael Sousa.
10.17^(10)	2015 Provider Solutions Cash Incentive Bonus Plan.
10.18^(11)	2016 Omnibus Plan.
10.19^	Form of HealthStream, Inc. Restricted Share Unit Agreement (Cumulative) under 2016 Omnibus Plan between HealthStream, Inc. and Michael Sousa.
21.1	Subsidiaries of HealthStream, Inc.
23.1	Consent of Independent Registered Public Accounting Firm
31.1	Certification of the Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of the Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.1 INS	XBRL Instance Document
101.1 SCH	XBRL Taxonomy Extension Schema
101.1 CAL	XBRL Taxonomy Extension Calculation Linkbase
101.1 DEF	XBRL Taxonomy Extension Definition Linkbase
101.1 LAB	XBRL Taxonomy Extension Label Linkbase
101.1 PRE	XBRL Taxonomy Extension Presentation Linkbase

* Incorporated by reference to Registrant s Registration Statement on Form S-1, as amended (Reg. No. 333-88939).
^ Management contract or compensatory plan or arrangement
(1) Incorporated by reference from exhibit filed on our Current Report on Form 8-K, dated February 13, 2015.
(2) Incorporated by reference from exhibit filed on our Current Report on Form 8-K, dated August 8, 2016.

(3) Incorporated by reference from exhibit filed on our Current Report on Form 8-K, dated July 25, 2005.
(4) Incorporated by reference from exhibit filed on our Current Report on Form 8-K, dated June 1, 2010.
(5) Incorporated by reference from exhibit filed on our Quarterly Report on Form 10-Q, for the quarterly period ended March 31, 2012 filed with the SEC on April 30, 2012.
(6) Incorporated by reference to Appendix B of the Company s Definitive Proxy Statement filed with the SEC on April 29, 2010.
(7) Incorporated by reference from exhibit filed on our Current Report on Form 8-K, dated November 25, 2014.
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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized on this 27th day of February, 2017.

HEALTHSTREAM, INC.

By: /s/ ROBERT A. FRIST, JR.
Robert A. Frist, Jr.
Chief Executive Officer

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

Signature	Title(s)	Date
/s/ ROBERT A. FRIST, JR.	President, Chief Executive Officer and	February 27, 2017
Robert A. Frist, Jr.	Chairman (Principal Executive Officer)	
/s/ GERARD M. HAYDEN, JR.	Chief Financial Officer and Senior Vice President	February 27, 2017
Gerard M. Hayden, Jr.	(Principal Financial and Accounting Officer)	
/s/ THOMPSON DENT	Director	February 27, 2017
Thompson Dent		
/s/ FRANK GORDON	Director	February 27, 2017
Frank Gordon		
/s/ C. MARTIN HARRIS	Director	February 27, 2017
C. Martin Harris		
/s/ JEFFREY L. MCLAREN	Director	February 27, 2017
Jeffrey L. McLaren		
/s/ DALE POLLEY	Director	February 27, 2017
Dale Polley		

/s/ LINDA REBROVICK	Director	February 27, 2017
Linda Rebrovick		
/s/ MICHAEL SHMERLING	Director	February 27, 2017
Michael Shmerling		
/s/ WILLIAM STEAD	Director	February 27, 2017
William Stead		
/s/ DEBORAH TAYLOR TATE	Director	February 27, 2017
Deborah Taylor Tate		

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