
HEALTHWAYS
2006 Annual Report
innovate

"Today's health consumer is more than a patient.

At any given time he or she may also be a researcher, caregiver, self manager and/or wellness shopper seeking solutions that proactively address any – or all – of their individual or family's health and care needs. HEALTHWAYS is the first to creatively respond to this 'whole consumer' with innovative and effective solutions that help maintain good health, manage disease and lead to better outcomes."

Joseph Coughlin, PhD,
Founder, MIT AgeLab

The MIT AgeLab develops new ideas to improve the quality of life for older adults and those who care for them.

Dr. Coughlin pictured in one of the AgeLab's innovations.

For the past quarter century, Healthways (NASDAQ: HWAY) has provided specialized, comprehensive Health and Care Support℠ solutions to help people maintain or improve their health and, as a result, reduce overall healthcare costs. Designed to provide highly specific and personalized interventions for each individual in a population, irrespective of health status, age, or payor, Healthways' evidence-based and proven services are made available to consumers by phone, mail, internet, and face-to-face interactions and are offered both domestically and internationally. As the recognized industry leader in the provision of health and care support programs, Healthways today serves millions of individuals worldwide.

Our market leadership position has been achieved through our consistent focus on core principles that guide our business and strategic decision-making:

- **We are market-driven, both in responding to market needs and in introducing innovations that create new value for our customers.**
- **Our solutions, across the spectrum of individual needs, are built on evidence- based science.**
- **Our commitment is to produce improved outcomes – health, financial, productivity and service experience – that are measurable, repeatable and scalable.**

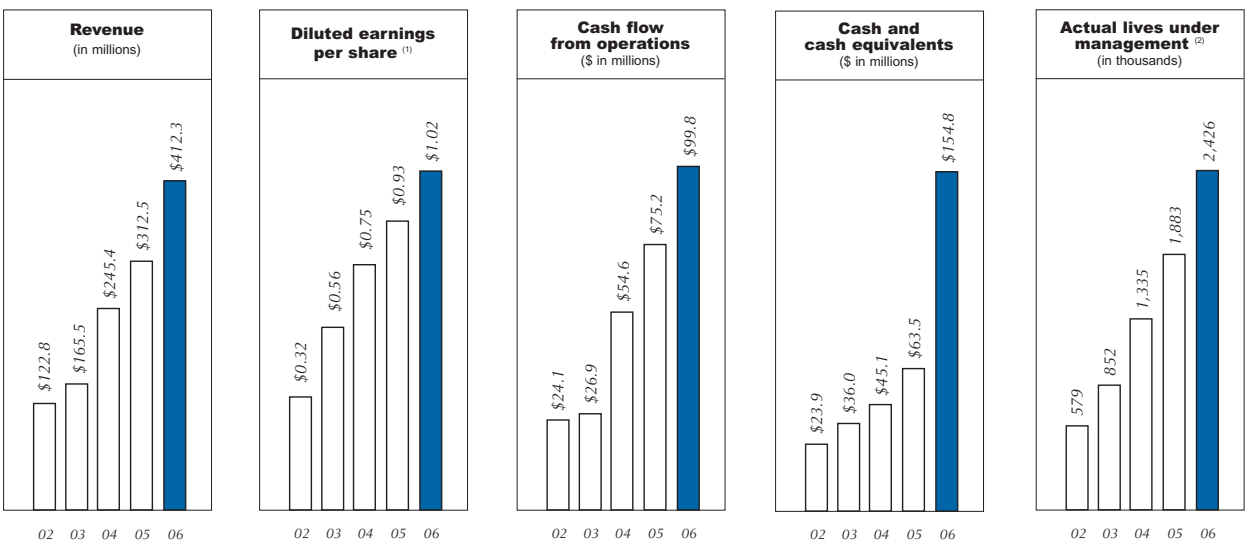
Predicated on the fundamental belief that healthier people cost less, Healthways' programs are designed to help keep healthy individuals healthy, mitigate and retard the progression to disease associated with family or lifestyle risk factors and promote the best possible health for those who are already affected by disease. At the same time, we recognize that each individual plays a variety of roles in their pursuit of health and care support, often simultaneously. By providing, on a fully integrated basis, and either totally or in partnership with our customers, the full spectrum of services to meet each individual's specific needs, we assure that our interventions can be delivered both at scale and in a manner that reflects the unique needs of each consumer over time. Further, Healthways' extensive and fully-accredited complementary and alternative provider network offers convenient and comfortable access to the significant number of individuals who seek health services outside of the traditional healthcare system.

For more information about Healthways and its Health and Care Support℠ solutions, visit www.healthways.com.

(In thousands, except per share and health plan lives data)	2006	2005
OPERATING DATA		
Revenues	$ 412,308	$ 312,504
Net income	$ 37,151	$ 33,084
Diluted earnings per share	$ 1.02	$ 0.93
Adjusted diluted earnings per share	$ 1.02	$ 0.75 (1)
Diluted weighted average common shares and equivalents	36,379	35,691
OPERATING STATISTICS		
Actual lives under management	2,426,000	1,883,000
FINANCIAL POSITION		
Cash and cash equivalents	$ 154,792	$ 63,467
Working capital	124,469	70,644
Total assets	382,386	270,954
Long-term debt	236	416
Other long-term liabilities	10,853	9,055
Stockholders' equity	274,873	206,930

(1) Includes the net pro forma impact of equity-based compensation during fiscal 2005. See page 41 for a reconciliation of GAAP and non-GAAP results.

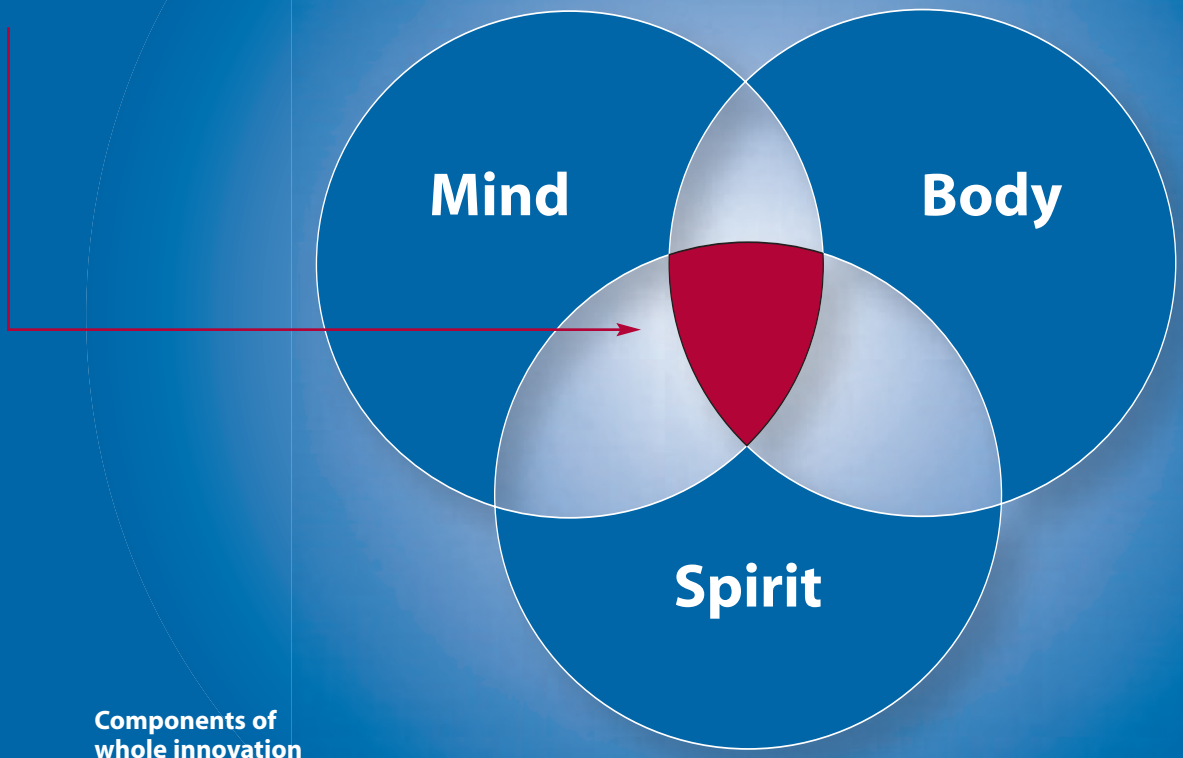
Financial Highlights



(1) Restated to reflect the effect of the November 2001 three-for-two stock split and the December 2003 two-for-one stock split.
(2) Restated to include the Company's hospital-based diabetes patients.

Our definition of innovation:

Whole Innovation responds to the whole consumer– Mind, Body & Spirit



Components of whole innovation for the consumer

Mind
(Informed Awareness)

- Status of well-being
- Provision of information
- Personal tools

Body
(Vitality and Design)

- Usability
- Focus on wellness, not disease alone
- Design experience

Spirit
(Secure Choices)

- Satisfaction
- Balanced choices, time, money, convenience
- Fun, entertaining

how do you define innovation?


together we
collaborate
to explore and achieve

Fellow Stockholders:

Innovation – guided by vision – is the key to growth. Fiscal 2006 was another year of strong profitable growth, with revenues and earnings per diluted share increasing 32% and 36%[1], respectively. For Heathways, innovation is the art of seeing ways to create new value, whether from applying better processes to old tasks or from true invention. "Whole innovation" is the art of creating new value by satisfying needs across all the dimensions of human experience - mind, body *and* spirit. Our focus on whole innovation has fueled our success and underlies the foundation for our future growth.

From our beginnings in 1981, Healthways has consistently pursued innovations that were anchored in evidence-based science, and yielded measurable, repeatable and improved outcomes for our customers. Now, as Healthways closes its silver anniversary year, it is clear that our embrace of continuous innovation has not only made us the industry leader in Health and Care Support℠ services, but also has positioned us for continued profitable growth on a scale that will make our expansion over the last quarter century seem nothing more than prologue. Because the strategic imperative for innovation has grown even more compelling, we suggest that, in addition to our strong financial performance for fiscal 2006, the important story of the past year is that our financial strength – and your continued confidence – enabled us to make significant investments in innovation that will provide the foundation for even greater growth going forward.

Our commitment to innovation remains focused on enhancing our ability to reach and engage whole populations through multiple delivery channels with integrated, personalized and proven evidenced-based interventions that maintain and improve the health of every individual. Among other initiatives, we took three major steps toward increasing both the comprehensiveness and integration of our programs since our last letter to you. Together with our new customer CareFirst, we brought to market a customized design and delivery model that combines coordinated, outcomes-driven wellness and care management solutions to address the needs of the health plan's total membership. Additionally, our acquisition of Axia Health Management, the nation's leading provider of preventive health and wellness programs, combined the premier companies in health support and care support solutions,

Brought together by Healthways to pursue next generation behavior change solutions, industry healthcare teams—led by Dr. Joseph Coughlin of the MIT AgeLab, Drs. James and Janice Prochaska of Pro-Change Behavior Systems, Dr. Josh Seidman of the Center for Information Therapy and Don Kemper of Healthwise—are engaged in ongoing collaboration to design and develop new behavior change solutions that will enhance our capability to help consumers move from passive to proactive, sustained health behaviors. The resulting web-based "virtual coach" will be the first mass-customized behavior change solution that will help create proactive health consumers irrespective of their perceived readiness to change.

"Partnering across the continuum of care has provided an exciting opportunity to bring the best that the science of behavior change has to bear for enhancing health and well-being. Creating the proactive health consumer through the development of the Next Generation Behavior Change product represents the next evolution of the science to optimize people's effectiveness in their roles as patients, purchasers, and providers of healthcare."

Drs. James & Janice Prochaska,
Founders, Pro-Change Behavior Systems, Inc.

[1] *See page 41 for a reconciliation of GAAP and non-GAAP results.*

significantly expanding Healthways' capabilities. And finally, through the creation of an unparalleled 10-year alliance with Medco, the nation's leading innovator in pharmacy benefit programs, we are taking meaningful steps to integrate and leverage pharmacy and medical management capabilities.

Through the acquisition of Axia, we are substantially expanding our ability to provide integrated Health and Care Support solutions with best-in-class interventions in physical activity, nutrition, weight management, smoking cessation, stress relief, early detection and screening. We also gain a national Health Provider Network for these interventions through 3,000 certified health improvement instructors, 10,000 fitness centers, 30,000 health and alternative care providers and robust web applications. Axia's programs are highly complementary to, and supportive of, our *myhealthIQ*℠ outcomes-driven wellness program. By enabling us to match specific individuals on a real time basis with the best, most qualified health providers in their local communities, this combination transforms our wellness capabilities and strengthens the differentiated solutions we offer in response to surging market demand for comprehensive, single-source programs and services.

Through the Medco alliance, we are launching the healthcare industry's first scaled initiative to achieve more effective and meaningful integration of health data, information and services from pharmacies, labs and other elements of the care management spectrum. By integrating real-time, patient specific pharmacy services with our high-touch outreach capabilities, we can more effectively and immediately impact medication therapy issues such as compliance and persistency thereby better addressing a critical component of an individual's care. This integration will enable us to achieve a level of timely, individualized support and outcomes that simply was not possible previously.

Our work with CareFirst, the Axia acquisition and the Medco alliance all accelerate our ability to provide personalized, comprehensive and integrated programs to entire populations, one person at a time. Each helps bring us closer to our goal of fully leveraging the potential of whole innovation to provide value to every person in a population—whether that person is completely healthy or has an acute, chronic or terminal illness; whether he or she is an infant, a child, or an adult of any age, living in the U.S. or abroad; whether the payor is Medicare, Medicaid or another government agency, a health plan, a self-insured employer, or, increasingly, individual consumers; and whether we reach out in person, by telephone, by mail or over the internet. The delivery method, the care provided, the payor may all vary from population to population – or within populations – but our mission to improve healthcare outcomes, and thereby reduce healthcare costs, remains exactly the same.

Recognizing the opportunity to create whole innovation requires both deep analytic capabilities and clear understanding of the needs of the market. The Center for Health Research gives Healthways, and the healthcare industry, a peer-reviewed source of scientifically valid conclusions about the drivers of health outcomes. From data collected over the course of our 25 years of helping individuals improve or maintain their health, the Center's experienced research team provides insight into the most effective ways to support consumers and providers in achieving improved health. Through this knowledge, we are able to more clearly define future models while improving our existing programs that, today, offer millions of people healthier and more productive lives.

"The Center for Health Research gives Healthways deep intelligence into the best possible design, implementation and execution of our services, while advancing our Health and Care Support platform. Our commitment to the Center is a direct reflection of our ongoing commitment to integrate knowledge in ways that improve health, improve quality and, as a result, reduce costs and improve productivity."

Carter R. Coberley, PhD,
Director of the Healthways Center for Health Research

analyze and

evaluate

to create new insight


design
and develop
new solutions

Even as we continuously improve our capabilities, we are also making significant progress in our initiatives to expand our addressable markets through multi-channel distribution.

Our core commercial health plan market continues to be our primary distribution channel and our strong core market growth continues to support all our other growth initiatives. For fiscal 2006, earnings per diluted share from our core market increased 49%[1], accelerating from the 37%[1] increase produced for fiscal 2005. This earnings growth reflects the expansion of actual lives under management at year end to 2,426,000, an increase of 543,000 lives for the year. More than one-half of this increase came from contracts with self-insured employers on behalf of our health plan customers. We completed fiscal 2006 with 526 employers under contract, compared with 372 at the end of fiscal 2005, and 954,000 self-insured lives under management, 313,000 or 49% above the end of fiscal 2005.

We are well positioned to continue achieving significant profitable growth within this core commercial market, which we estimate is currently an $8 billion opportunity. We expect to expand lives under management within existing contracts, through contract expansions, new contracts with new health plans and continued penetration of the self-insured employer market. With the acquisition of Axia, we have a substantial cross-sell opportunity among our combined customer base of over 120 health plans. Our initiatives to expand our Medicare Advantage business will benefit from Axia's well-known SilverSneakers® Fitness program for nearly 3 million Medicare-eligible members in 42 states. In addition, the initial focus of our Medco alliance is to market existing and developing products and services to Medco's clients – health plans, employers and public-sector organizations - which represent more than 40 million unique lives nationwide.

We also expect to produce further progress toward achieving targeted savings in the two Medicare Health Support (MHS) pilots in which we are participating. In our first year, we generated savings and improved clinical outcomes, and we did so in a manner that received very high satisfaction scores from the Medicare beneficiaries in each pilot. The savings we achieved allowed us to recognize a portion of the associated revenues from the pilots. While these savings did not meet our original expectations for

Through our Optimal Health® alliance with Medco, we achieve what no single company could alone: the integration of pharmacy and medical management services allowing for

more personalized and timely interventions

that produce market-leading outcomes.

A unique pay-for-quality incentive program designed by HealthSpring and Healthways resulted in each affiliated physician receiving the maximum possible quality bonus for meeting the program's goals. But a redesign of the physicians' office workflow,

dramatically improved clinical and financial outcomes

and a real improvement in patients' quality of life proved to be the greatest success stories.

"We firmly believe in the power of a population-wide approach for effectively managing the health of our members. With the fully integrated, robust health management program we are designing with Healthways, we will be able to promote better care for our members, and enable them to receive tailored guidance to deal with their specific health and lifestyle issues."

Jon Shematek, M.D., Vice President of Quality and Medical Policy,
CareFirst BlueCross BlueShield

[1] *See page 41 for a reconciliation of GAAP and non-GAAP results.*

With the addition of Axia's proven wellness and preventive programs, Healthways will present to the market the industry's

most innovative solution

to deliver, at scale, services that are highly personalized, convenient and fun for the consumer to engage.

"With Axia's comprehensive wellness programs, Healthways can deliver what no other company can – a complete Health and Care Support solution for consumers regardless of where they are in their health continuum and over the course of their entire life."

Ben Lytle, former CEO of Axia Health Management

the first year, we remain confident that we will achieve the objectives laid out by the Centers for Medicare and Medicaid Services (CMS) by the pilots' conclusion two years from now. We continue to expect that successful performance under the MHS pilots will position Healthways to participate in an expanded Medicare opportunity, which, combined with other government payment programs, represents an annual market opportunity of approximately $12 billion.

Healthways' international initiatives also continue to develop as governments and other payors in countries in Europe, South America and the Asia/Pacific region react to rising healthcare costs with the same urgency and commitment that we experience domestically. During fiscal 2006, we focused on developing our management organization for our international effort and on creating the legal infrastructure required in high priority countries. We also worked to translate our programs as needed to be effective in other countries. While we have not included any revenue from international initiatives in our financial guidance for fiscal 2007, we believe that we will execute our first international contract during fiscal 2007, establishing Healthways' initial presence in a market we estimate at more than $20 billion annually.

New solutions, new channels, new markets, and new science – all creating new value – comprised our innovation initiatives for fiscal 2006 and remain our focus for fiscal 2007. Taken together, they represent the foundation for our goal to be the leading world-wide provider of solutions that measurably improve the quality and reduce the cost of healthcare. The innovation underlying these initiatives responds directly to the strategic imperatives of our customers to address relentlessly rising healthcare costs with comprehensive, integrated, single-source and proven solutions. Healthways' demonstrated ability to innovate – to create new value – has enabled a unique and differentiated position for our Company and sustained, profitable growth for our stockholders.

Perhaps Will Rogers said it best: *"Even if you're on the right track, you'll get run over if you just sit there."* As we again made clear during fiscal 2006, Healthways is not just sitting there.

We close by recognizing all of our colleagues at Healthways and by thanking them for their talent, skills, dedication and determination that have driven this Company's historic success and created its future opportunities. They are responsible for the value proposition we deliver daily to our customers, as well as the market leadership and earnings growth that are responsible for our historic and future expansion in stockholder value.

Sincerely,

Ben R. Leedle, Jr.
President and Chief Executive Officer

engaging
populations to

deliver

improved health

Management Team

Standing left to right: Robert E. Stone, James E. Pope, MD, Ben R. Leedle, Jr., Mary D. Hunter
Seated left to right: Mary A. Chaput, Donald B. Taylor, Robert L. Chaput

Executive Officers

Ben R. Leedle, Jr.
President and Chief Executive Officer

Mary A. Chaput
Executive Vice President and Chief Financial Officer

James E. Pope, MD
Executive Vice President and Chief Operating Officer

Robert E. Stone
Executive Vice President and Chief Strategy Officer

Mary D. Hunter
Executive Vice President

Donald B. Taylor
Executive Vice President, Sales and Marketing

Matthew Kelliher
Executive Vice President, International Business

Robert L. Chaput
Executive Vice President and Chief Information Officer

Selected Financial Data

Year ended and at August 31, (In thousands, except per share data)	2006[4][5]	2005[4]	2004[4]	2003	2002
Operating Results: [1]					
Revenues	$ 412,308	$ 312,504	$ 245,410	$ 165,471	$ 122,762
Cost of services	281,161	205,253	156,462	106,130	84,845
Gross margin	131,147	107,251	88,948	59,341	37,917
Selling, general and administrative expenses	44,417	28,418	23,686	16,511	12,726
Depreciation and amortization	24,517	22,408	18,450	10,950	7,271
Interest	1,053	1,630	3,509	569	370
	69,987	52,456	45,645	28,030	20,367
Income before income taxes	61,160	54,795	43,303	31,311	17,550
Income tax expense	24,009	21,711	17,245	12,837	7,195
Net income	$ 37,151	$ 33,084	$ 26,058	$ 18,474	$ 10,355
Basic income per share: [2]	$ 1.08	$ 1.00	$ 0.81	$ 0.60	$ 0.35
Diluted income per share: [2]	$ 1.02	$ 0.93	$ 0.75	$ 0.56	$ 0.32
Weighted average common shares and equivalents: [2]					
Basic	34,348	33,241	32,264	31,048	29,945
Diluted	36,379	35,691	34,632	33,010	32,188
Balance Sheet Data: [1]					
Cash and cash equivalents	$ 154,792	$ 63,467	$ 45,147	$ 35,956	$ 23,924
Working capital	124,469	70,644	55,462	47,047	24,295
Total assets	382,386	270,954	253,449	140,013	118,017
Long-term debt	236	416	36,562	109	514
Other long-term liabilities	10,853	9,055	7,694	4,662	3,568
Stockholders' equity	274,873	206,930	155,435	112,431	88,809
Other Operating Data:					
Actual lives under management [3]	2,426	1,883	1,335	852	579
Annualized revenue in backlog	$ 6,625	$ 32,578	$ 15,200	$ 12,200	$ 27,600

[1] Certain items in prior periods have been reclassified to conform to current classifications.

[2] Restated to reflect the effect of the December 2003 two-for-one stock split.

[3] Restated to include the Company's hospital-based diabetes patients.

[4] Includes operating results, balance sheet data, and other operating data of StatusOne since the date of the acquisition, which was September 5, 2003.

[5] Includes $15.3 million of costs related to equity-based awards expensed under Statement of Financial Accounting Standards ("SFAS") No. 123(R) and cash-based awards issued in lieu of equity-based awards that were historically granted to certain levels of management. These cash-based awards are a result of changes in the design of the Company's long-term incentive compensation program in preparation for adopting SFAS No. 123(R) on September 1, 2005.

Management's Discussion and Analysis of Financial Condition and Results of Operation

Overview

Founded in 1981, Healthways, Inc. (formerly American Healthways, Inc.) (the "Company") provides specialized, comprehensive Health and Care Support℠ programs and services, including disease management, high-risk care management, and Outcomes Driven Wellness℠ programs to health plans, governments, employers, and hospitals in all 50 states, the District of Columbia, Puerto Rico, and Guam. These services include, but are not limited to:

- providing members with educational materials and personal interactions with highly trained nurses and other health-care professionals designed to create and sustain healthier behaviors;
- incorporating current evidence-based clinical guidelines in interventions to optimize patient care;
- developing care support plans and motivating members to set attainable goals for themselves;
- providing local market resources to address acute episode interventions;
- coordinating members' care with local health-care providers; and
- fostering wellness and prevention through total population screening, health risk assessments, and supportive interventions.

Our integrated Health and Care Support programs serve entire customer populations through member and physician Health and Care Support interventions, advanced neural network predictive modeling, and a confidential, secure Internet-based application that provides patients and physicians with individualized health information. Our programs enable our customers to develop relationships with all of their members and to identify those at highest risk for a health problem, allowing for early interventions.

Our programs are designed to help people lead healthier lives by making sure they understand and follow doctors' orders including medication compliance, are aware of and can recognize early warning signs associated with a major health episode, and are setting achievable goals for themselves to improve their current health status.

We believe that our patient and physician support regimens, delivered and/or supervised by a multi-disciplinary team, have demonstrated that they assist in providing more effective care for the enrollee populations diagnosed with one or more diseases or conditions, which will improve the health status of the enrollee populations with the disease or condition and reduce both the short-term and long-term health-care costs for these enrollees. In addition, our consumer-directed health support services enable health plans and employers to reach and engage everyone in their covered populations through interventions which are sensitive and specific to each individual's health risks and needs, thereby motivating behavior change and generating measurable cost savings.

Our integrated Health and Care Support product line includes programs for people with diabetes, coronary artery disease, heart failure, asthma, chronic obstructive pulmonary disease, end-stage renal disease, cancer, chronic kidney disease, depression, tobacco addiction, high-risk obesity, acid-related stomach disorders, atrial fibrillation, decubitus ulcer, fibromyalgia, hepatitis C, inflammatory bowel disease, irritable bowel syndrome, low-back pain, osteoarthritis, osteoporosis, and urinary incontinence. We also provide high-risk care management and population health support. We design our programs to create and maintain key desired behaviors of each program member and of the providers who care for them in order to improve member health status, thereby reducing health-care costs. The programs incorporate interventions designed to optimize member care and are based on the most up-to-date, evidence-based clinical guidelines.

The flexibility of our programs allows customers to enter the Health and Care Support market at the level they deem appropriate for their organization. Customers may select a single chronic disease or a total population approach, in which all members of the customer's population receive the benefit of our programs at a single cost.

In October 2006, we entered into a stock purchase agreement with Axia Health Management, Inc. ("Axia"), a national provider of preventive health and wellness programs, to purchase all of Axia's outstanding shares of capital stock for approximately $450 million, subject to adjustment for Axia's indebtedness, working capital, and cash balance at closing. Of the purchase price, $35 million will be held in escrow until December 31, 2007 to satisfy any potential indemnification claims. An additional $9 million of the purchase price will be held in escrow to satisfy a portion of certain potential earnout obligations. We expect the acquisition to close during December 2006, subject to satisfaction of the closing conditions in the

Management's Discussion and Analysis of Financial Condition and Results of Operation

stock purchase agreement, including receipt of required regulatory approvals. We currently anticipate that the acquisition will be financed through a combination of cash on hand and committed bank debt.

We have seen increasing demand for our Health and Care Support services from self-insured employer accounts, most of which are contracted through the Administrative Services Only (ASO) line of business with our health plan customers and for which our health plan customers do not assume medical cost risk but provide primarily administrative claim and health network access services. Signed contracts between these self-insured employers and our health plan customers are incorporated in our contracts with our health plan customers, and these program-eligible members are included in actual lives under management or annualized revenue in backlog, as appropriate.

Highlights of Fiscal 2006 Performance

- Revenues increased 31.9% over fiscal 2005.
- Net income for fiscal 2006, which included $15.3 million of costs related to share-based compensation expensed under SFAS No. 123(R) as well as cash-based awards issued in lieu of share-based compensation that was historically granted to certain levels of management, increased 12.3% over fiscal 2005, which included share-based compensation costs of $0.5 million.
- Actual lives under management increased 28.8% from the end of fiscal 2005 to the end of fiscal 2006, which included a 48.8% increase in self-insured employer actual lives under management to 954,000 at the end of fiscal 2006 from 641,000 at the end of fiscal 2005.

Forward-Looking Statements

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

- our ability to sign and implement new contracts for Health and Care Support services;
- our ability to accurately forecast performance and the timing of revenue recognition under the terms of our contracts ahead of data collection and reconciliation in order to provide forward-looking guidance;
- the timing and costs of implementation, and the effect, of regulations and interpretations relating to the Medicare Prescription Drug, Improvement, and Modernization Act of 2003;
- our ability to anticipate the rate of market acceptance of Health and Care Support solutions and the individual market dynamics in potential international markets and our ability to accurately forecast the costs necessary to implement our strategy of establishing a presence in these markets;
- our ability to effectively manage any growth that we might experience;
- our ability to retain existing health plan customers if they decide to take programs in-house or are acquired by other health plans which already have or are not interested in Health and Care Support programs;
- the risks associated with a significant concentration of our revenues with a limited number of customers;
- our ability to effect cost savings and clinical outcomes improvements under Health and Care Support contracts and reach mutual agreement with customers with respect to cost savings, or to effect such savings and improvements within the time frames contemplated by us;
- our ability to collect contractually earned performance incentive bonuses;
- the ability of our customers to provide timely and accurate data that is essential to the operation and measurement of our performance under the terms of our contracts;
- our ability to favorably resolve contract billing and interpretation issues with our customers;

- our ability to satisfy the closing conditions in the Axia stock purchase agreement, including receipt of required regulatory approvals, and to satisfy the conditions of our financing commitment;
- increased leverage expected to be incurred in conjunction with the anticipated acquisition of Axia;
- our ability to integrate the operations of Axia and other acquired businesses or technologies into our business and to achieve the results provided in our guidance with respect to Axia;
- our ability to develop new products and deliver outcomes on those products, including those anticipated from our strategic relationship with Medco, Inc.;
- our ability to effectively integrate new technologies and approaches, such as those encompassed in our Health and Care Support initiatives or otherwise licensed or acquired by us, into our Health and Care Support platform;
- our ability to renew and/or maintain contracts with our customers under existing terms or restructure these contracts on terms that would not have a material negative impact on our results of operations;
- our ability to implement our Health and Care Support strategy within expected cost estimates;
- our ability to obtain adequate financing to provide the capital that may be necessary to support the growth of our operations and to support or guarantee our performance under new contracts;
- unusual and unforeseen patterns of health care utilization by individuals with diabetes, cardiac, respiratory and/or other diseases or conditions for which we provide services;
- the ability of our customers to maintain the number of covered lives enrolled in the plans during the terms of our agreements;
- our ability to attract and/or retain and effectively manage the employees required to implement our agreements;
- the impact of litigation involving us and/or our subsidiaries;
- the impact of future state and federal health care and other applicable legislation and regulations on our ability to deliver our services and on the financial health of our customers and their willingness to purchase our services;
- current geopolitical turmoil and the continuing threat of domestic or international terrorism;
- general worldwide and domestic economic conditions and stock market volatility; and
- other risks detailed in the Company's other filings with the Securities and Exchange Commission.

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

Critical Accounting Policies

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

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

Revenue Recognition

We generally determine our contract fees by multiplying a contractually negotiated rate per member per month ("PMPM") by the number of members covered by our services during the month. We set the PMPM rates during contract negotiations with customers based on the value we expect our programs to create and a sharing of that value between the customer and the Company. In some contracts, the PMPM rates may differ between a customer's lines of business (e.g., PPO, HMO, Medicare Advantage). Contracts with health plans generally range from three to seven years with provisions for subsequent renewal; contracts between our health plan customers and their self-insured employer accounts typically have one-year terms.

Management's Discussion and Analysis of Financial Condition and Results of Operation

Some contracts provide that a portion (up to 100%) of our fees may be refundable to the customer ("performance-based") if our programs do not achieve, when compared to a baseline year, a targeted percentage reduction in the customer's health-care costs and selected clinical and/or other criteria that focus on improving the health of the members. Approximately 10% of revenues recorded during fiscal 2006 were performance-based and were subject to final reconciliation as of August 31, 2006. We anticipate that this percentage will fluctuate due to the level of performance-based fees in new contracts, revenue recognition associated with performance-based fees, and the timing of data reconciliation, which varies according to contract terms. A limited number of contracts also provide opportunities for us to receive incentive bonuses in excess of the contractual PMPM rate if we exceed contractual performance targets.

We are participating in two Medicare Health Support ("MHS") pilots awarded under the Chronic Care Improvement Program authorized by the Medicare Modernization Act of 2003. The pilots will operate for 36 months and may be terminated by either party with six months written notice. We began operating one pilot in August 2005 to serve 20,000 Medicare fee-for-service beneficiaries in Maryland and the District of Columbia. All fees under this pilot are performance-based. In addition, in September 2005 we began serving 20,000 beneficiaries in Georgia in collaboration with CIGNA HealthCare, Inc. The majority of our fees under our contract with CIGNA are performance-based. Both of the pilots are for complex diabetes and congestive heart failure disease management services and are operationally similar to our programs for commercial and Medicare Advantage health plan populations.

In June 2006, we signed an amendment to our cooperative agreement with the Centers for Medicare & Medicaid Services ("CMS") for our MHS stand-alone pilot in Maryland and the District of Columbia, which, among other things, enabled us to provide congestive heart failure programs to approximately 4,500 additional Medicare fee-for-service beneficiaries for two years beginning on August 1, 2006 (the "refresh population"). All fees for the refresh population are performance-based.

We bill our customers each month for the entire amount of the fees contractually due for the prior month's enrollment, which typically includes the amount, if any, that is performance-based and may be subject to refund should we not meet performance targets. Contractually, we cannot bill for any incentive bonus until after contract settlement.

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

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

Substantially all of the fees under both the MHS pilots and the refresh population in which we are participating are performance-based. The pilots require that, by the end of the third year, we achieve a cumulative net savings (total savings for the intervention population as compared to the control group less fees received from CMS) of five percent. The cumulative net savings targets are lower at the beginning of the pilots and increase in gradual increments, ending with a cumulative net savings target of five percent at the end of the pilots. Under the amendment of our stand-alone MHS pilot in Maryland and the District of Columbia, the refresh population will be a separate cohort served for two years, by the end of which the program is expected to achieve a 2.5% cumulative net savings when compared to a new control cohort. Under the stand-alone pilot, savings in excess of target achieved in either the original cohort or the refresh cohort can be applied against any savings deficit that might occur in the other cohort. Although we receive the medical claims and other data associated with the intervention group under these pilots on a monthly basis, we assess our performance against the control group under these pilots based on quarterly performance reports received from CMS' financial reconciliation contractor.

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

During the settlement process under a contract, which generally occurs six to eight months after the end of a contract year, we settle any performance-based fees and reconcile health-care claims and clinical data. As of August 31, 2006, performance-based fees that have not yet been settled with our customers but that have been recognized as revenue in the current and prior years, including performance-based fees recognized as revenue under the MHS pilots, which will not be settled with the customer until the end of the pilots, totaled approximately $54.3 million. Of this amount, $19.9 million was based on calculations which include estimates such as medical claims incurred but not reported and/or the customer's medical cost trend compared to a baseline year, while $34.4 million was based entirely on actual data received from our customers. Data reconciliation differences, for which we provide contractual allowances until we reach agreement with respect to identified issues, can arise between the customer and us due to customer data deficiencies, omissions, and/or data discrepancies.

Performance-related adjustments (including any amounts recorded as revenue that were ultimately refunded), changes in estimates, data reconciliation differences, or adjustments to incentive bonuses may cause us to recognize or reverse revenue in a current fiscal year that pertains to services provided during the prior fiscal year. During fiscal 2006, we recognized a net increase in revenue of $1.6 million that related to services provided prior to fiscal 2006.

Impairment of Intangible Assets and Goodwill

In accordance with Statement of Financial Accounting Standards ("SFAS") No. 142 "Goodwill and Other Intangible Assets," we review goodwill for impairment on an annual basis or more frequently whenever events or circumstances indicate that the carrying value may not be recoverable.

If we determine that the carrying value of goodwill is impaired based upon an impairment review, we calculate any impairment using a fair-value-based goodwill impairment test as required by SFAS No. 142. Fair value is the amount at which the asset could be bought or sold in a current transaction between two willing parties. We estimate fair value using a number of techniques, including quoted market prices or valuations by third parties, present value techniques based on estimates of cash flows, or multiples of earnings or revenues performance measures.

We amortize other identifiable intangible assets, such as acquired technologies and customer contracts, on the straight-line method over their estimated useful lives, except for trade names, which have an indefinite life and are not subject to amortization. We review intangible assets not subject to amortization on an annual basis or more frequently whenever events or circumstances indicate that the assets might be impaired. We assess the potential impairment of intangible assets subject to amortization whenever events or changes in circumstances indicate that the carrying values may not be recoverable.

If we determine that the carrying value of other identifiable intangible assets may not be recoverable, we calculate any impairment using an estimate of the asset's fair value based on the projected net cash flows expected to result from that asset, including eventual disposition.

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

Share-Based Compensation

On September 1, 2005, we adopted SFAS No. 123(R), "Share-Based Payment," which requires us to measure and recognize compensation expense for all share-based payment awards based on estimated fair

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values at the date of grant. Determining the fair value of share-based awards at the grant date requires judgment in developing assumptions, which involve a number of variables. These variables include, but are not limited to, the expected stock price volatility over the term of the awards, and expected stock option exercise behavior. In addition, we also use judgment in estimating the number of share-based awards that are expected to be forfeited. We contract with a third party to assist in developing the assumptions used in estimating the fair values of stock options.

Business Strategy

Our primary strategy is to create value for health plans, governments, employers, and hospitals through Health and Care Support programs and services that improve the quality and affordability of health-care. We plan to use our scalable state-of-the-art care enhancement centers, medical information content, and proprietary technologies to gain a competitive advantage in delivering our Health and Care Support services.

We expect to continue adding services to our product mix that extend our programs beyond a chronic disease focus and provide services to individuals who currently have, or face the risk of developing, one or more additional medical conditions. We believe that we can achieve improvements in care and significant cost savings by addressing care and treatment requirements for these additional selected diseases and conditions, which will enable us to address an increasingly larger percentage of a customer's population and total health-care costs. As discussed above, in October 2006, we entered into a stock purchase agreement to acquire Axia, a national provider of preventive health and wellness programs, which we expect to close during December 2006.

In May 2006 we entered into a strategic partnership with Medco, Inc., a leading pharmacy benefit management company, to distribute existing programs and to develop integrated medical and pharmaceutical management programs. We expect to continue developing proprietary, proactive health support products and services for whole populations across the continuum of care, including next generation integrated disease management and wellness solutions.

We anticipate that we will incur significant costs during fiscal 2007 to enhance and expand our clinical programs and data and financial reporting systems, pursue opportunities in international markets, enhance our information technology support, integrate the operations of Axia, and open additional or expand current care enhancement centers as needed. We may add some of these new capabilities and technologies through internal development, strategic alliances with other entities, and/or through selective acquisitions.

Results of Operations

The following table shows the components of the statements of operations for the fiscal years ended August 31, 2006, 2005 and 2004 expressed as a percentage of revenues.

	Year ended August 31,		
	2006	2005	2004
Revenues	100.0%	100.0%	100.0%
Cost of services	68.2%	65.7%	63.8%
Gross margin	31.8%	34.3%	36.2%
Selling, general and administrative expenses	10.8%	9.1%	9.7%
Depreciation and amortization	5.9%	7.2%	7.5%
Interest expense	0.3%	0.5%	1.4%
Income before income taxes	14.8%	17.5%	17.6%
Income tax expense	5.8%	6.9%	7.0%
Net income	9.0%	10.6%	10.6%

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Revenues

Revenues for fiscal 2006 and fiscal 2005 increased 31.9% and 27.3%, respectively, over the prior fiscal years. Fiscal 2006 revenues increased over fiscal 2005 revenues primarily due to the following:

- existing customers adding or expanding 25 programs since the beginning of fiscal 2005;
- an increase in self-insured employer actual lives under management from 641,000 at August 31, 2005 to 954,000 at August 31, 2006;
- the commencement of 9 new contracts since the beginning of fiscal 2005;
- increased membership in customers' existing programs; and
- increased revenues from the MHS pilots of $11.0 million during fiscal 2006 compared to fiscal 2005.

Fiscal 2005 revenues increased over fiscal 2004 revenues primarily due to the following:

- an increase in self-insured employer actual lives under management from 361,000 at August 31, 2004 to 641,000 at August 31, 2005;
- existing customers adding or expanding 29 programs since the beginning of fiscal 2004;
- the commencement of 10 new contracts since the beginning of fiscal 2004; and
- increased membership in customers' existing programs.

We anticipate that fiscal 2007 revenues will increase over fiscal 2006 revenues primarily due to the expansion of existing contracts, increasing demand for our Health and Care Support services from self-insured employers who contract with our health plan customers or with Medco, anticipated new health plan contracts, increased revenues from MHS pilots, and the pending acquisition of Axia,.

Cost of Services

Cost of services as a percentage of revenues increased to 68.2% for fiscal 2006 compared to 65.7% for fiscal 2005. This increase is primarily related to the following:

- revenues and costs related to the two MHS pilots, which began in August and September of 2005, respectively. A significant portion of the performance-based fees under these three-year pilots has not yet been recognized as revenue because the contracts are in their early stages and we have not yet achieved 100% of the cumulative net savings target. During fiscal 2006, we recorded revenues of $11.2 million and costs of $21.3 million attributable to the MHS pilots compared to $0.2 million of revenues and $4.8 million of costs during fiscal 2005; and
- long-term incentive compensation costs of $7.5 million incurred during fiscal 2006, including share-based compensation expensed under SFAS No. 123(R) and cash-based awards issued in lieu of share-based awards that were historically granted to certain levels of management, compared to no share-based compensation costs during fiscal 2005.

Excluding the revenues and costs associated with the MHS pilots and the long-term incentive compensation costs noted above, cost of services as a percentage of revenues decreased to 62.9% from 64.2% for fiscal 2006 and 2005, respectively, primarily due to increased capacity utilization, economies of scale, and productivity enhancements during fiscal 2006 compared to fiscal 2005.

Cost of services as a percentage of revenues increased to 65.7% for fiscal 2005 compared to 63.8% for fiscal 2004. Excluding contract performance incentive bonus revenues, which totaled $2.5 million for fiscal 2004 compared to $0.2 million for fiscal 2005, cost of services as a percentage of revenues increased to 65.7% from 64.4% for fiscal 2005 and 2004, respectively, primarily as a result of the following:

- an increase in accrued employee bonuses; and
- increased expenses related to securing and preparing for MHS pilots during fiscal 2005 compared to fiscal 2004.

These increases were partially offset by decreases attributable to initial operating costs in fiscal 2004 related to the opening of two new care enhancement centers in January 2004 and March 2004 and increased capacity utilization, economies of scale, and productivity enhancements during fiscal 2005 compared to fiscal 2004.

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We anticipate that fiscal 2007 cost of services will increase over fiscal 2006 primarily as a result of increases in operating staff required for expected increases in demand for our services, increases in indirect staff costs associated with the continuing development and implementation of our Health and Care Support services, increases in information technology and other support staff and costs, and the incremental cost of services attributable to Axia.

Selling, General and Administrative Expenses

Selling, general and administrative expenses as a percentage of revenues increased to 10.8% for fiscal 2006 compared to 9.1% for fiscal 2005, primarily related to the following costs:

- costs attributable to pursuing opportunities in international markets, which totaled $3.2 million and $0.7 million for fiscal 2006 and 2005, respectively; and
- long-term incentive compensation costs of $7.8 million during fiscal 2006, which consisted of share-based compensation expensed under SFAS No. 123(R) and cash-based awards issued in lieu of share-based awards that were historically granted to certain levels of management, compared to $0.5 million of share-based compensation costs during fiscal 2005.

Excluding the costs above, selling, general and administrative expenses as a percentage of revenues decreased to 8.1% for fiscal 2006 compared to 8.7% for fiscal 2005, primarily due to our ability to more effectively leverage our selling, general and administrative expenses as a result of growth in our operations.

Selling, general and administrative expenses as a percentage of revenues decreased to 9.1% for fiscal 2005 compared to 9.7% for fiscal 2004, primarily due to our ability to more effectively leverage our selling, general and administrative expenses as a result of growth in our operations. These decreases were partially offset by an increase in accrued employee bonuses and increased expenses related to securing and preparing for MHS pilots during fiscal 2005 compared to fiscal 2004.

We anticipate that selling, general and administrative expenses for fiscal 2007 will increase over fiscal 2006 primarily due to anticipated investments in international initiatives, increases in selling, general and administrative costs in support of our existing and anticipated new and expanded contracts, incremental selling, general and administrative costs attributable to Axia, and costs related to the integration of Axia.

Depreciation and Amortization

Depreciation and amortization expense for fiscal 2006 increased 9.4% compared to fiscal 2005 and 21.5% for fiscal 2005 compared to fiscal 2004, primarily due to increased depreciation expense associated with capital expenditures to enhance our information technology capabilities and expand our corporate office and calling capacity at existing care enhancement centers.

We anticipate that depreciation and amortization expense for fiscal 2007 will increase over fiscal 2006 primarily as a result of 1) anticipated amortization expense associated with the estimated identifiable intangible assets expected to be recorded upon completion of the Axia acquisition, and 2) additional capital expenditures associated with expected increases in demand for our services and growth and improvement in our information technology capabilities.

Interest Expense

Interest expense for fiscal 2006 decreased 35.4% compared to fiscal 2005 primarily because we had no bank debt outstanding during fiscal 2006.

Interest expense for fiscal 2005 decreased 53.5% compared to fiscal 2004 primarily due to a reduction in our long-term debt balance resulting from net repayments of $48.0 million of revolving debt during fiscal 2005, as well as lower interest rates under the First Amended and Restated Revolving Credit Loan Agreement dated October 29, 2004 ("the First Amended Credit Agreement") compared to the Revolving Credit and Term Loan Agreement dated September 5, 2003 (the "Former Credit Agreement") (described more fully in "Liquidity and Capital Resources" below).

We anticipate that interest expense for fiscal 2007 will increase over fiscal 2006 primarily as a result of anticipated financing costs attributable to borrowings expected to be incurred in conjunction with the Axia acquisition.

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Income Tax Expense

Our effective tax rate decreased to 39.3% for fiscal 2006 compared to 39.6% and 39.8% for fiscal 2005 and 2004, respectively, primarily as a result of changes in our geographic mix of earnings, which impacts our average state income tax rate, and other factors. The differences between the statutory federal income tax rate of 35.0% and our effective tax rate are due primarily to the impact of state income taxes and certain non-deductible expenses for income tax purposes. We anticipate that our effective tax rate for fiscal 2007 will increase over fiscal 2006 primarily as a result of an expected increase in costs related to international initiatives in fiscal 2007.

Liquidity and Capital Resources

Cash and cash equivalents increased $91.3 million during fiscal 2006 to $154.8 million at August 31, 2006 from $63.5 million at August 31, 2005. The increase was primarily due to cash flow from operations and the exercise of stock options, partially offset by capital expenditures.

Operating activities for fiscal 2006 generated cash of $99.8 million compared to $75.2 million for fiscal 2005. The increase in operating cash flow of $24.6 million resulted primarily from 1) an increase in cash collections recorded to contract billings in excess of earned revenue for fiscal 2006 compared to fiscal 2005, primarily related to the MHS pilots; and 2) payments during fiscal 2005 related to accounts payable accrued at August 31, 2004 associated with capital expenditures for upgrades to hardware in support of core business functions. These increases to cash were partially offset by 1) an increase in accounts receivable primarily resulting from increased revenues due to growth in our business; 2) a higher employee bonus payment during fiscal 2006 compared to fiscal 2005; and 3) the reclassification of the tax benefit of stock option exercises from operating cash flows during fiscal 2005 to financing cash flows during fiscal 2006, as required by SFAS No. 123(R).

Investing activities during fiscal 2006 used $27.5 million in cash which consisted almost entirely of investments in property and equipment, primarily associated with the addition of information technology hardware and software, the opening of a new care enhancement center, and expansions at existing care enhancement centers.

Financing activities for fiscal 2006 provided $19.0 million in cash primarily due to proceeds from the exercise of stock options and the related tax benefit. In addition, we received from escrow $3.8 million that was previously classified as restricted cash due to contractual requirements with a customer and was reclassified to cash and cash equivalents as our first-year results were validated with the customer.

On September 19, 2005, we amended and restated the First Amended Credit Agreement and entered into the Second Amended Credit Agreement, which provides us with a $250.0 million revolving credit facility, including a swingline sub facility of $10.0 million and a $75.0 million sub facility for letters of credit, together with an uncommitted incremental accordion facility of $50.0 million, and expires on September 19, 2010. As of August 31, 2006, our available line of credit totaled $249.3 million.

The Second Amended Credit Agreement requires us to repay the principal on any loans at the maturity date of September 19, 2010. Borrowings under the Second Amended Credit Agreement generally bear interest, at our option, at LIBOR plus a spread of 0.875% to 1.5%, which is dependent on the ratio of total funded debt to EBITDA, or at the prime rate. The Second Amended Credit Agreement also provides for a fee ranging between 0.175% and 0.3% of unused commitments. The Second Amended Credit Agreement is secured by guarantees from our active domestic subsidiaries and by security interests in substantially all of our and our subsidiaries' assets.

The First Amended Credit Agreement provided us with up to $150.0 million in borrowing capacity and contained various financial covenants, which required us to maintain, as defined, ratios or levels of (i) total funded debt to EBITDA, (ii) interest coverage, (iii) fixed charge coverage, and (iv) net worth. The Second Amended Credit Agreement contains similar financial covenants with the exclusion of the interest coverage ratio. Both agreements restrict the payment of dividends and limit the amount of repurchases of the Company's common stock. As of August 31, 2006, we were in compliance with all of the covenant requirements of the Second Amended Credit Agreement.

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As of August 31, 2006, there were letters of credit outstanding under the Second Amended Credit Agreement totaling $0.7 million primarily to support our requirement to repay fees under one health plan contract in the event we do not perform at established target levels and do not repay the fees due in accordance with the terms of the contract.

We believe that cash flow from operating activities, our available cash, and our expected available credit under committed bank debt will continue to enable us to meet our contractual obligations and to fund the current level of growth in our operations for the foreseeable future. However, if expanding our operations requires significant additional financing resources, such as capital expenditures for technology improvements, additional care enhancement centers and/or letters of credit or other forms of financial assurance to guarantee our performance under the terms of new contracts, or if we are required to refund performance-based fees pursuant to contract terms, we may need to raise additional capital by expanding our existing credit facility and/or issuing debt or equity. If we face a limited ability to arrange such financing, it may restrict our ability to expand our operations.

As discussed above, in October 2006, we entered into a stock purchase agreement to acquire Axia. We currently anticipate that the acquisition will be financed through a combination of cash on hand and committed bank debt. In connection with the acquisition, we entered into a commitment letter with respect to credit facilities under which we may borrow up to $600.0 million, including a revolving credit facility of up to $400.0 million and a term loan facility of $200.0 million, consisting of a term loan B. Pursuant to the commitment letter, our ability to borrow under the credit facilities is subject to various conditions that are customary for a transaction of this type.

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

Contractual Obligations

The following schedule summarizes our contractual cash obligations by the indicated period as of August 31, 2006:

	Payments Due By Year Ended August 31,				
	2007	2008 - 2009	2010 - 2011	2012 and After	Total
(In $000s)					
Capital lease obligations	$ 214	$ 251	$ –	$ –	$ 465
Deferred compensation plan payments	1,442	2,175	550	3,971	8,138
Operating lease obligations [1]	8,054	17,795	18,889	72,005	116,743
Other contractual cash obligations [2]	2,400	4,075	1,500	–	7,975
Total Contractual Cash Obligations	$ 12,110	$ 24,296	$ 20,939	$ 75,976	$ 133,321

[1] In May 2006, we entered into an office lease agreement for our new corporate headquarters containing approximately 255,000 square feet of rentable area. The term of the lease is 15 years and will commence on the date that the premises are ready for occupancy, which is expected to be before March 1, 2008. The base rent for the initial 15-year term will be based on the actual construction costs of the building and is expected to range from $16.38 per square foot to $24.88 per square foot over the term.

[2] Other commitments represent cash payments in connection with our strategic alliance agreements and exclude certain variable costs related to one strategic alliance that are based on the number of future eligible members.

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Recently Issued Accounting Standards

Accounting for Uncertainty in Income Taxes

In June 2006 the FASB issued FIN No. 48, "Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109." FIN No. 48 creates a single model to address uncertainty in income tax positions by prescribing the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. It also provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition. It is effective for fiscal years beginning after December 15, 2006. We do not yet know the impact that the adoption of FIN No. 48 will have on our financial position or results of operations.

Fair Value Measurement

In September 2006 the FASB issued SFAS No. 157, "Fair Value Measurement," which provides guidance for using fair value to measure assets and liabilities, including a fair value hierarchy that prioritizes the information used to develop fair value assumptions. It also requires expanded disclosure about the extent to which companies measure assets and liabilities at fair value, the information used to measure fair value, and the effect of fair value measurements on earnings. The standard applies whenever other standards require (or permit) assets or liabilities to be measured at fair value and does not expand the use of fair value in any new circumstances.

SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. We do not expect the adoption of SFAS No. 157 to have a material impact on our financial position or results of operations.

Effect of Prior Year Misstatements on Current Year Misstatements

In September 2006 the Securities and Exchange Commission staff published Staff Accounting Bulletin ("SAB") No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements," which requires that companies quantify errors under both the "rollover" and "iron curtain" methods and evaluate the misstatement of the current year financial statements calculated under each approach. The rollover method quantifies a misstatement based on the effects of correcting the misstatement existing in the current period income statement, while the iron curtain method quantifies a misstatement based on the effects of correcting the misstatement existing in the balance sheet at the end of the current period, regardless of the misstatement's period(s) of origin. After considering all relevant quantitative and qualitative factors, if either approach results in a misstatement that is material, a company must adjust its financial statements.

SAB No. 108 is effective for fiscal years ending after November 15, 2006. We do not expect the adoption of SAB No. 108 to have a material impact on our financial position or results of operations.

Quantitative and Qualitative Disclosures About Market Risk

We are subject to market risk related to interest rate changes, primarily as a result of the Second Amended Credit Agreement, the First Amended Credit Agreement, and the Former Credit Agreement, which bear interest based on floating rates. Borrowings under the First Amended Credit Agreement bore interest, at our option, at the prime rate plus a spread of 0.0% to 1.0% or LIBOR plus a spread of 1.25% to 2.25%, which was dependent on the ratio of total funded debt to EBITDA, or a combination thereof. Borrowings under the Second Amended Credit Agreement generally bear interest, at our option, at LIBOR plus a spread of 0.875% to 1.5%, which is dependent on the ratio of total funded debt to EBITDA, or at the prime rate. As of August 31, 2006, we do not execute transactions or hold derivative financial instruments for trading purposes.

Because there was no variable rate debt outstanding during fiscal 2006, a one-point interest rate change would not have caused interest expense to fluctuate for fiscal 2006.

Consolidated Balance Sheets

At August 31, (In thousands, except share and per share data)	2006	2005
Assets		
Current assets:		
Cash and cash equivalents	$ 154,792	$ 63,467
Restricted cash	–	3,811
Accounts receivable, net	52,978	40,697
Prepaid expenses and other current assets	9,397	5,681
Deferred tax asset	3,726	3,305
Total current assets	220,893	116,961
Property and equipment:		
Leasehold improvements	16,009	12,836
Computer equipment and related software	75,524	61,772
Furniture and office equipment	18,542	16,294
	110,075	90,902
Less accumulated depreciation	(63,525)	(51,114)
Net property and equipment	46,550	39,788
Long-term deferred tax asset	2,557	–
Other assets	4,052	2,065
Intangible assets, net	12,199	16,120
Goodwill, net	96,135	96,020
Total assets	$ 382,386	$ 270,954
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$ 9,221	$ 3,622
Accrued salaries and benefits	36,007	26,845
Accrued liabilities	5,748	5,006
Contract billings in excess of earned revenue	35,013	8,037
Income taxes payable	7,906	660
Current portion of long-term debt	180	163
Current portion of long-term liabilities	2,349	1,984
Total current liabilities	96,424	46,317
Long-term debt	236	416
Long-term deferred tax liability	–	8,236
Other long-term liabilities	10,853	9,055
Stockholders' equity		
Preferred stock $.001 par value, 5,000,000 shares authorized, none outstanding	–	–
Common stock $.001 par value, 75,000,000 shares authorized, 34,597,748 and 33,808,518 shares outstanding	35	34
Additional paid-in capital	140,216	109,425
Retained earnings	134,622	97,471
Total stockholders' equity	274,873	206,930
Total liabilities and stockholders' equity	$ 382,386	$ 270,954

See accompanying notes to the consolidated financial statements.

Consolidated Statements of Operations

Year ended August 31,	2006	2005	2004
(In thousands, except earnings per share data)			
Revenues	$ 412,308	$ 312,504	$ 245,410
Cost of services	281,161	205,253	156,462
Gross margin	131,147	107,251	88,948
Selling, general and administrative expenses	44,417	28,418	23,686
Depreciation and amortization	24,517	22,408	18,450
Interest expense	1,053	1,630	3,509
Income before income taxes	61,160	54,795	43,303
Income tax expense	24,009	21,711	17,245
Net income	$ 37,151	$ 33,084	$ 26,058
Earnings per share:			
Basic	$ 1.08	$ 1.00	$ 0.81
Diluted	$ 1.02	$ 0.93	$ 0.75
Weighted average common shares and equivalents			
Basic	34,348	33,241	32,264
Diluted	36,379	35,691	34,632

See accompanying notes to the consolidated financial statements.

Consolidated Statements of Changes in Stockholders' Equity

(In thousands)	Preferred Stock	Common Stock	Additional Paid–in Capital	Retained Earnings	Accumulated Other Comprehensive Income	Total
Balance, August 31, 2003	$ –	$ 32	$ 74,070	$ 38,329	$ –	$ 112,431
Net income	–	–	–	26,058	–	26,058
Net change in fair value of interest rate swap, net of income taxes of $23	–	–	–	–	35	35
Total comprehensive income						26,093
Exercise of stock options and other	–	1	5,085	–	–	5,086
Tax benefit of option exercises	–	–	10,013	–	–	10,013
Issuance of stock in conjunction with strategic alliance	–	–	1,812	–	–	1,812
Balance, August 31, 2004	$ –	$ 33	$ 90,980	$ 64,387	$ 35	$ 155,435
Net income	–	–	–	33,084	–	33,084
Termination of interest rate swap	–	–	–	–	(35)	(35)
Total comprehensive income						33,049
Exercise of stock options and other	–	1	5,229	–	–	5,230
Tax benefit of option exercises	–	–	11,672	–	–	11,672
Issuance of stock in conjunction with Health IQ acquisition	–	–	1,544	–	–	1,544
Balance, August 31, 2005	$ –	$ 34	$109,425	$ 97,471	$ –	$ 206,930
Net income	–	–	–	37,151	–	37,151
Exercise of stock options and other	–	1	5,342	–	–	5,343
Tax benefit of option exercises	–	–	11,467	–	–	11,467
Share-based employee compensation expense	–	–	13,982	–	–	13,982
Balance, August 31, 2006	$ –	$ 35	$140,216	$134,622	$ –	$ 274,873

See accompanying notes to the consolidated financial statements.

Consolidated Statements of Cash Flows

Year ended August 31, (In thousands)	2006	2005	2004
Cash flows from operating activities:			
Net income	$ 37,151	$ 33,084	$ 26,058
Adjustments to reconcile net income to net cash provided by operating activities, net of business acquisitions:			
Depreciation and amortization	24,517	22,408	18,450
Amortization of deferred loan costs	476	488	768
Share-based employee compensation expense	13,982	494	820
Excess tax benefits from share-based payment arrangements	(10,936)	11,672	10,013
Increase in accounts receivable, net	(12,281)	(6,485)	(7,174)
(Increase) decrease in other current assets	(3,716)	1,098	(1,425)
Increase (decrease) in accounts payable	5,599	(3,562)	4,824
Increase (decrease) in accrued salaries and benefits	9,162	18,880	(3,959)
Increase in other current liabilities	46,434	820	3,040
Deferred income taxes	(11,217)	(5,456)	(468)
Other	3,621	2,003	3,841
(Increase) decrease in other assets	(1,539)	633	231
Payments on other long-term liabilities	(1,445)	(872)	(371)
Net cash flows provided by operating activities	99,808	75,205	54,648
Cash flows from investing activities:			
Acquisition of property and equipment	(27,356)	(16,161)	(26,189)
Purchases of investments	–	(2,000)	(6,000)
Proceeds on sale of investments	–	9,040	70
Business acquisitions, net of cash acquired	(115)	(1,120)	(60,223)
Net cash flows used in investing activities	(27,471)	(10,241)	(92,342)
Cash flows from financing activities:			
Decrease (increase) in restricted cash	3,811	(2,287)	(1,524)
Proceeds from issuance of long-term debt	–	48,000	60,000
Deferred loan costs	(924)	(730)	(2,315)
Excess tax benefits from share-based payment arrangements	10,936	–	–
Exercise of stock options	5,328	4,599	4,258
Payments of long-term debt	(163)	(96,226)	(12,424)
Net cash flows provided by (used in) financing activities	18,988	(46,644)	47,995
Net increase in cash and cash equivalents	91,325	18,320	10,301
Cash and cash equivalents, beginning of period	63,467	45,147	34,846
Cash and cash equivalents, end of period	$ 154,792	$ 63,467	$ 45,147
Supplemental disclosure of cash flow information:			
Cash paid during the year for interest	$ 548	$ 1,099	$ 2,749
Cash paid during the year for income taxes	$ 16,415	$ 18,198	$ 6,367
Noncash Activities:			
Issuance of unregistered common stock associated with Health IQ acquisition	$ –	$ 1,544	$ –
Issuance of unregistered common stock associated with Outcomes Verification Program	$ –	$ –	$ 1,812

See accompanying notes to the consolidated financial statements.

Notes to Consolidated Financial Statements
Years Ended August 31, 2006, 2005 and 2004

1. Summary of Significant Accounting Policies

Healthways, Inc. (formerly American Healthways, Inc.) and its wholly-owned subsidiaries provide specialized, comprehensive Health and Care Support programs and services to health plans, governments, employers, and hospitals in all 50 states, the District of Columbia, Puerto Rico and Guam.

We have reclassified certain items in prior periods to conform to current classifications.

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

b. Cash and Cash Equivalents - Cash and cash equivalents primarily include tax-exempt debt instruments, repurchase agreements, commercial paper, and other short-term investments with original maturities of less than three months. We also include in cash and cash equivalents any accrued interest related to these items.

c. Restricted Cash – Restricted cash at August 31, 2005 represented funds held in escrow in connection with a contractual requirement with a customer. In accordance with the terms of the contract, in January 2006 the entire $3.8 million was released from escrow and reclassified to cash and cash equivalents as our first-year results were validated with the customer.

d. Accounts Receivable - Billed receivables primarily represent fees that are contractually due in the ordinary course of providing our services, net of contractual adjustments. Unbilled receivables primarily represent fees that have been earned but that cannot be billed for until a contractually specified time, typically less than one year. Historically, we have experienced minimal instances of customer non-payment and therefore consider our accounts receivable to be collectible, but we may provide reserves, when appropriate, for billing adjustments at contract reconciliation.

e. Property and Equipment - Property and equipment is carried at cost and includes expenditures that increase value or extend useful lives. We recognize depreciation using the straight-line method over useful lives of three years for computer software and hardware and five to seven years for furniture and other office equipment. Leasehold improvements are depreciated over the shorter of the estimated life of the asset or the life of the lease, which ranges from two to eleven years. Depreciation expense for the years ended August 31, 2006, 2005, and 2004 was $20.6 million, $18.5 million, and $14.2 million, respectively, including amortization of assets recorded under capital leases.

f. Other Assets - Other assets consist primarily of deferred loan costs net of accumulated amortization.

g. Intangible Assets - Intangible assets subject to amortization primarily include acquired technology and customer contracts, which we amortize on a straight-line basis over a five-year estimated useful life. We assess the potential impairment of intangible assets subject to amortization whenever events or changes in circumstances indicate that the carrying values may not be recoverable.

Intangible assets not subject to amortization consist of a trade name of $4.3 million. We review intangible assets not subject to amortization on an annual basis or more frequently whenever events or circumstances indicate that the assets might be impaired. See Note 4 for further information on intangible assets.

h. Goodwill - We recognize goodwill for the excess of the purchase price over the fair value of tangible and identifiable intangible net assets of businesses that we acquire. The change in the carrying amount of goodwill for fiscal 2006 primarily relates to an earn-out agreement under which we are obligated to pay the former stockholders of Health IQ Diagnostics, LLC (“Health IQ”) additional purchase price equal to a percentage of revenues recognized from Health IQ’s programs in each of the fiscal quarters during the three-year period ending August 31, 2008 (see Note 3). Accumulated amortization of goodwill at August 31, 2006 and 2005 was $5.1 million.

In accordance with Statement of Financial Accounting Standards (“SFAS”) No. 142, “Goodwill and Other Intangible Assets,” we review goodwill at least annually for impairment. We completed our annual impairment test as of June 30, 2006 as required by SFAS No. 142 and concluded that no impairment of

goodwill exists. In connection with the adoption of SFAS No. 142, we also reassessed the useful lives and the classification of our identifiable intangible assets and determined that they continue to be appropriate.

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

j. Income Taxes - We file a consolidated federal income tax return that includes all of our domestic wholly-owned subsidiaries. We compute our income tax provision under SFAS No. 109, "Accounting for Income Taxes." SFAS No. 109 generally requires that we record deferred income taxes for the tax effect of differences between the book and tax bases of our assets and liabilities.

k. Revenue Recognition - We generally determine our contract fees by multiplying a contractually negotiated rate per member per month ("PMPM") by the number of members covered by our services during the month. We set the PMPM rates during contract negotiations with customers based on the value we expect our programs to create and a sharing of that value between the customer and the Company.

Some contracts provide that a portion (up to 100%) of our fees may be refundable to the customer ("performance-based") if our programs do not achieve, when compared to a baseline year, a targeted percentage reduction in the customer's health-care costs and selected clinical and/or other criteria that focus on improving the health of the members. Approximately 10% of revenues recorded during fiscal 2006 were performance-based and were subject to final reconciliation as of August 31, 2006. We anticipate that this percentage will fluctuate due to the level of performance-based fees in new contracts, revenue recognition associated with performance-based fees, and the timing of data reconciliation, which varies according to contract terms. A limited number of contracts also provide opportunities for us to receive incentive bonuses in excess of the contractual PMPM rate if we exceed contractual performance targets.

We are participating in two Medicare Health Support ("MHS") pilots awarded under the Chronic Care Improvement Program authorized by the Medicare Modernization Act of 2003. The pilots will operate for 36 months and may be terminated by either party with six months written notice. We began operating one pilot in August 2005 to serve 20,000 Medicare fee-for-service beneficiaries in Maryland and the District of Columbia. All fees under this pilot are performance-based. In addition, in September 2005 we began serving 20,000 beneficiaries in Georgia in collaboration with CIGNA HealthCare, Inc. The majority of our fees under our contract with CIGNA are performance-based. Both of the pilots are for complex diabetes and congestive heart failure disease management services and are operationally similar to our programs for commercial and Medicare Advantage health plan populations.

In June 2006, we signed an amendment to our cooperative agreement with the Centers for Medicare & Medicaid Services ("CMS") for our MHS stand-alone pilot in Maryland and the District of Columbia, which, among other things, enabled us to provide congestive heart failure programs to approximately 4,500 additional Medicare fee-for-service beneficiaries for two years beginning on August 1, 2006 (the "refresh population"). All fees for the refresh population are performance-based.

We bill our customers each month for the entire amount of our fees contractually due for the prior month's enrollment, which typically includes the amount, if any, that is performance-based and may be subject to refund should we not meet performance targets. Contractually, we cannot bill for any incentive bonus until after contract settlement.

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

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

Notes to Consolidated Financial Statements
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Substantially all of the fees under both the MHS pilots and the refresh population in which we are participating are performance-based. The pilots require that, by the end of the third year, we achieve a cumulative net savings (total savings for the intervention population as compared to the control group less fees received from CMS) of five percent. The cumulative net savings targets are lower at the beginning of the pilots and increase in gradual increments, ending with a cumulative net savings target of five percent at the end of the pilots. Under the amendment of our stand-alone MHS pilot in Maryland and the District of Columbia, the refresh population will be a separate cohort served for two years, by the end of which the program is expected to achieve a 2.5% cumulative net savings when compared to a new control cohort. Under the stand-alone pilot, savings in excess of target achieved in either the original cohort or the refresh cohort can be applied against any savings deficit that might occur in the other cohort. Although we receive the medical claims and other data associated with the intervention group under these pilots on a monthly or more frequent basis, we assess our performance against the control group under these pilots based on quarterly performance reports received from CMS' financial reconciliation contractor.

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

During the settlement process under a contract, which generally occurs six to eight months after the end of a contract year, we settle any performance-based fees and reconcile health-care claims and clinical data. As of August 31, 2006, performance-based fees that have not yet been settled with our customers but that have been recognized as revenue in the current and prior years, including performance-based fees recognized as revenue under the MHS pilots, which will not be settled with the customer until the end of the pilots, totaled approximately $54.3 million. Of this amount, $19.9 million was based on calculations which include estimates such as medical claims incurred but not reported and/or the customer's medical cost trend compared to a baseline year, while $34.4 million was based entirely on actual data received from our customers. Data reconciliation differences, for which we provide contractual allowances until we reach agreement with respect to identified issues, can arise between the customer and us due to customer data deficiencies, omissions, and/or data discrepancies.

Performance-related adjustments (including any amounts recorded as revenue that were ultimately refunded), changes in estimates, data reconciliation differences, or adjustments to incentive bonuses may cause us to recognize or reverse revenue in a current fiscal year that pertains to services provided in the prior fiscal year. During fiscal 2006, we recognized a net increase in revenue of $1.6 million that related to services provided prior to fiscal 2006.

l. Earnings Per Share - We report earnings per share under SFAS No. 128 "Earnings per Share". We calculate basic earnings per share using weighted average common shares outstanding during the period. We calculate diluted earnings per share using weighted average common shares outstanding during the period plus the effect of all dilutive potential common shares outstanding during the period.

m. Share-Based Compensation - We account for share-based compensation in accordance with SFAS No. 123(R), "Share-Based Payment" which is a revision of SFAS No. 123, "Accounting for Stock-Based Compensation." SFAS No. 123(R) supersedes Accounting Principles Board Opinion ("APB") No. 25, "Accounting for Stock Issued to Employees," and requires that all share-based payments to employees, including grants of employee stock options, be recognized in the income statement based on their fair values.

As permitted by SFAS No. 123, prior to September 1, 2005 we accounted for share-based payments to employees and outside directors using APB No. 25's intrinsic value method and adopted the disclosure requirements of SFAS No. 123 and SFAS No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure - an Amendment of FASB Statement No. 123." As such, we generally recognized no compensation cost for employee stock options prior to fiscal 2006.

See Note 9 for further information on share-based compensation.

Notes to Consolidated Financial Statements
Years Ended August 31, 2006, 2005 and 2004

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

2. Recently Issued Accounting Standards

Accounting for Uncertainty in Income Taxes

In June 2006 the FASB issued FIN No. 48, "Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109." FIN No. 48 creates a single model to address uncertainty in income tax positions by prescribing the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. It also provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition. It is effective for fiscal years beginning after December 15, 2006. We do not yet know the impact that the adoption of FIN No. 48 will have on our financial position or results of operations.

Fair Value Measurement

In September 2006 the FASB issued SFAS No. 157, "Fair Value Measurement," which provides guidance for using fair value to measure assets and liabilities, including a fair value hierarchy that prioritizes the information used to develop fair value assumptions. It also requires expanded disclosure about the extent to which companies measure assets and liabilities at fair value, the information used to measure fair value, and the effect of fair value measurements on earnings. The standard applies whenever other standards require (or permit) assets or liabilities to be measured at fair value and does not expand the use of fair value in any new circumstances.

SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. We do not expect the adoption of SFAS No. 157 to have a material impact on our financial position or results of operations.

Effect of Prior Year Misstatements on Current Year Misstatements

In September 2006 the Securities and Exchange Commission staff published Staff Accounting Bulletin ("SAB") No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements," which requires that companies quantify errors under both the "rollover" and "iron curtain" methods and evaluate the misstatement of the current year financial statements calculated under each approach. The rollover method quantifies a misstatement based on the effects of correcting the misstatement existing in the current period income statement, while the iron curtain method quantifies a misstatement based on the effects of correcting the misstatement existing in the balance sheet at the end of the current period, regardless of the misstatement's period(s) of origin. After considering all relevant quantitative and qualitative factors, if either approach results in a misstatement that is material, a company must adjust its financial statements.

SAB No. 108 is effective for fiscal years ending after November 15, 2006. We do not expect the adoption of SAB No. 108 to have a material impact on our financial position or results of operations.

3. Goodwill

The change in carrying amount of goodwill during the years ended August 31, 2006 and 2005 is shown below:

(In $000s)	
Balance, August 31, 2004	$ 93,574
Health IQ acquisition and related costs	3,622
StatusOne purchase price adjustments	(1,176)
Balance, August 31, 2005	$ 96,020
Health IQ purchase price adjustment	115
Balance, August 31, 2006	$ 96,135

Notes to Consolidated Financial Statements
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The Health IQ acquisition and related costs of $3.6 million during fiscal 2005 relate to the acquisition of Health IQ in June 2005. The StatusOne purchase price adjustments during fiscal 2005 primarily relate to $1.3 million that we received from escrow during the first quarter of fiscal 2005 after the termination of the StatusOne Health Systems, LLC ("StatusOne") escrow agreement. The Health IQ purchase price adjustment of $0.1 million during fiscal 2006 primarily relates to an earn-out agreement under which we are obligated to pay the former stockholders of Health IQ additional purchase price equal to a percentage of revenues recognized from Health IQ's programs in each of the fiscal quarters during the three-year period ending August 31, 2008.

4. Intangible Assets

Intangible assets subject to amortization at August 31, 2006 consist of the following:

(In $000s)	Gross Carrying Amount	Accumulated Amortization	Net
Acquired technology	$ 10,163	$ 6,098	$ 4,065
Customer contracts	9,179	5,519	3,660
Other	200	70	130
Total	$ 19,542	$ 11,687	$ 7,855

Intangible assets subject to amortization at August 31, 2005 consisted of the following:

(In $000s)	Gross Carrying Amount	Accumulated Amortization	Net
Acquired technology	$ 10,163	$ 4,065	$ 6,098
Customer contracts	9,233	3,725	5,508
Other	200	30	170
Total	$ 19,596	$ 7,820	$ 11,776

Acquired technology, customer contracts, and other intangible assets are being amortized on a straight-line basis over a five-year estimated useful life. Total amortization expense for the years ended August 31, 2006 and 2005 was $3.9 million. Estimated amortization expense is $3.9 million for each of the next two fiscal years and $40,000, $10,000 and zero for the three fiscal years thereafter, respectively.

Intangible assets not subject to amortization at August 31, 2006 and 2005 consist of a trade name associated with the StatusOne acquisition of $4.3 million.

5. Income Taxes

Income tax expense is comprised of the following:

Year ended August 31, (In $000s)	2006	2005	2004
Current taxes			
Federal	$ 29,247	$ 22,750	$ 14,729
State	5,977	4,416	3,016
Deferred taxes			
Federal	(9,312)	(4,941)	(165)
State	(1,903)	(514)	(335)
Total	$ 24,009	$ 21,711	$ 17,245

Notes to Consolidated Financial Statements
Years Ended August 31, 2006, 2005 and 2004

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. The following table shows the significant components of our net deferred tax asset (liability) for the fiscal years ended August 31, 2006 and 2005:

At August 31, (In $000s)	2006	2005
Deferred tax assets:		
Accruals and reserves	$ 2,681	$ 2,375
Spin-off stock option adjustment	13	21
Deferred compensation	5,111	4,370
Share based payments	5,523	–
Capital loss carryforward	97	97
	13,425	6,863
Valuation allowance	(97)	(97)
	13,328	6,766
Deferred tax liability:		
Tax over book depreciation	2,312	5,465
Tax over book amortization	4,733	6,232
	7,045	11,697
Net deferred tax asset (liability)	$ 6,283	$ (4,931)
Net current deferred tax assets	$ 3,726	$ 3,305
Net long-term deferred tax asset (liability)	2,557	(8,236)
	$ 6,283	$ (4,931)

We recorded a valuation allowance totaling approximately $97,000 against deferred tax assets as of August 31, 2006 and 2005 because management believes it is more likely than not that the net deferred tax asset related to a capital loss carryforward will not be realized in future tax periods. The capital loss carryforward will expire if unused by August 31, 2007. For fiscal 2006 and 2005, the tax benefit of stock option compensation, excluding tax benefit either relieving the deferred tax asset described as "Spin-off stock option adjustment" or related to the deferred tax asset for share-based payments subject to SFAS No. 123(R), is recorded as additional paid-in capital.

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

Year ended August 31, (In $000s)	2006	2005	2004
Statutory federal income tax	$ 21,406	$ 19,178	$ 15,156
State income taxes, less federal income tax benefit	2,495	2,249	1,743
Other	108	284	346
Income tax expense	$ 24,009	$ 21,711	$ 17,245

6. Long–Term Debt

On September 19, 2005, we entered into a Second Amended and Restated Revolving Credit Loan Agreement (the "Second Amended Credit Agreement"). The Second Amended Credit Agreement provides us with a $250.0 million revolving credit facility, including a swingline sub facility of $10.0 million and a $75.0 million sub facility for letters of credit, together with an uncommitted incremental accordion facility of $50.0 million, and expires on September 19, 2010. As of August 31, 2006, our available line of credit totaled $249.3 million.

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The Second Amended Credit Agreement requires us to repay the principal on any loans at the maturity date of September 19, 2010. Borrowings under the Second Amended Credit Agreement generally bear interest, at our option, at LIBOR plus a spread of 0.875% to 1.5%, which is dependent on the ratio of total funded debt to EBITDA, or at the prime rate. The Second Amended Credit Agreement also provides for a fee ranging between 0.175% and 0.3% of unused commitments. The Second Amended Credit Agreement is secured by guarantees from our active domestic subsidiaries and by security interests in substantially all of our and our subsidiaries' assets.

The Second Amended Credit Agreement contains various financial covenants, which require us to maintain, as defined, ratios or levels of (i) total funded debt to EBITDA, (ii) fixed charge coverage, and (iii) net worth. It also restricts the payment of dividends and limits the amount of repurchases of the Company's common stock. As of August 31, 2006, we were in compliance with all of the covenant requirements of the Second Amended Credit Agreement.

As of August 31, 2006, there were letters of credit outstanding under the Second Amended Credit Agreement for $0.7 million primarily to support our requirement to repay fees under one health plan contract in the event we do not perform at established target levels and do not repay the fees due in accordance with the terms of the contract.

To meet the reporting requirements of SFAS No. 107, "Disclosures About Fair Value of Financial Instruments," we calculate the estimated fair value of financial instruments using quoted market prices of similar instruments or discounted cash flow techniques. At August 31, 2006 and 2005, there were no material differences between the carrying amount and the fair value of our debt.

7. Other Long-Term Liabilities

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

As of August 31, 2006 and 2005, other long-term liabilities included vested amounts under the plan of $6.7 million and $5.4 million, respectively, net of the current portion of $1.4 million. For the next five fiscal years, we must make plan payments of $1.4 million for the first two fiscal years, and $0.8 million, $0.3 million, and $0.2 million, for the next three fiscal years, respectively.

8. Leases

We maintain operating lease agreements principally for our corporate office space and our ten care enhancement centers. Our corporate office leases cover approximately 150,000 square feet and expire from August 2007 to May 2009. Our support and training offices for StatusOne contain approximately 23,000 square feet of space in aggregate and have initial terms ranging from two to five years. The care enhancement center leases cover approximately 15,000 to 33,000 square feet each and have initial terms of approximately five to eleven years.

In May 2006, we entered into an office lease agreement for our new corporate headquarters to be located near Nashville, Tennessee containing approximately 255,000 square feet of rentable area. The term of the lease is 15 years and will commence on the date that the premises are ready for occupancy, which is expected to be before March 1, 2008. The lease also provides for two renewal options of five years each at then prevailing market rates. The base rent for the initial 15-year term will be based on the actual construction costs of the building and is expected to range from $16.38 per square foot to $24.88 per square foot over the term.

Most of our operating leases include escalation clauses, some of which are fixed amounts, and some of which reflect changes in price indices. Certain operating leases contain renewal options to extend the lease for additional periods. Our capital lease obligation contains an option to purchase the leased property for a specified amount at the end of the lease term. For the years ended August 31, 2006, 2005 and 2004, rent expense under lease agreements was approximately $7.7 million, $6.0 million, and $4.9 million, respectively.

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

Year ending August 31, (In $000s)	Capital Leases	Operating Leases
2007	$ 214	$ 8,054
2008	214	8,116
2009	37	9,679
2010	—	9,808
2011	—	9,081
2012 and thereafter	—	72,005
Total minimum lease payments	465	$ 116,743
Less amount representing interest	(49)	
Present value of net minimum lease payments	416	
Less current portion	(180)	
	$ 236	

9. Share-Based Compensation

We have several shareholder-approved stock incentive plans for employees and directors. We currently have three types of share-based awards outstanding under these plans: stock options, restricted stock, and restricted stock units. We believe that such awards align the interests of our employees and directors with those of our stockholders. Prior to September 1, 2005, we accounted for these plans under the recognition and measurement provisions of APB No. 25 and related interpretations, as permitted by SFAS No. 123, "Accounting for Stock-Based Compensation."

For the years ended August 31, 2005 and 2004, we recorded compensation expense under APB No. 25 of approximately $0.5 million and $0.8 million, respectively. This expense resulted primarily from the grant, which was subject to stockholder approval, of stock options to two new directors of the Company in June 2003. We obtained such approval at the Annual Meeting of Stockholders in January 2004, at which time we issued the options. We also recognized a total income tax benefit in the statement of operations for share-based compensation arrangements of $0.2 million and $0.3 million for the years ended August 31, 2005 and 2004, respectively. We generally recognize compensation expense related to fixed award stock options with graded vesting on a straight-line basis over the vesting period.

Effective September 1, 2005, we adopted SFAS No. 123(R) using the modified prospective transition method. Under the modified prospective transition method, recognized compensation cost for the year ended August 31, 2006 includes 1) compensation cost for all share-based payments granted prior to, but not yet vested as of, September 1, 2005, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123; and 2) compensation cost for all share-based payments granted on or after September 1, 2005, based on the grant date fair value estimated in accordance with SFAS No. 123(R). In accordance with the modified prospective method, we have not restated prior period results.

For the year ended August 31, 2006, we recognized share-based compensation costs of $14.0 million, which consisted of $6.6 million in cost of services and $7.4 million in selling, general and administrative expenses. We also recognized a total income tax benefit in the statement of operations for share-based compensation arrangements of $5.5 million for the year ended August 31, 2006. We did not capitalize any share-based compensation costs during fiscal 2006, 2005, or 2004.

As a result of adopting SFAS No. 123(R), income before income taxes and net income for the year ended August 31, 2006 were $14.0 million and $8.4 million lower, respectively, than if we had continued to account for share-based compensation under APB 25. The effect of adopting SFAS No. 123(R) on both basic and diluted earnings per share for the year ended August 31, 2006 was $0.25 and $0.23 per share, respectively.

Prior to adopting SFAS No. 123(R), we presented the tax benefit of stock option exercises as operating cash flows. SFAS No. 123(R) requires that tax benefits resulting from tax deductions in excess of the compensation cost recognized for those options be classified as financing cash flows.

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SFAS No. 123(R) also requires companies to calculate an initial "pool" of excess tax benefits available at the adoption date to absorb any tax deficiencies that may be recognized under SFAS No.123(R). The pool includes the net excess tax benefits that would have been recognized if the company had adopted SFAS No. 123 for recognition purposes on its effective date.

We have elected to calculate the pool of excess tax benefits under the alternative transition method described in FASB Staff Position ("FSP") No. FAS 123(R)-3, "Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards," which also specifies the method we must use to calculate excess tax benefits reported on the statement of cash flows. The excess tax benefits from share-based payment arrangements classified as a financing cash inflow for the year ended August 31, 2006 of $10.9 million would not have been materially different if we had not adopted SFAS No. 123(R); however, they would have been classified as an operating cash inflow rather than as a financing cash inflow.

The following table illustrates the effect on net income and earnings per share if we had applied the fair value recognition provisions of SFAS No. 123 to stock-based employee compensation for the years ended August 31, 2005 and 2004:

Year ended August 31, (In $000s, except per share data)	2005	2004
Net income, as reported	$ 33,084	$ 26,058
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects	299	493
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(6,709)	(5,097)
Pro forma net income	$ 26,674	$ 21,454
Earnings per share:		
Basic - as reported	$ 1.00	$ 0.81
Basic - pro forma	$ 0.80	$ 0.66
Diluted - as reported	$ 0.93	$ 0.75
Diluted - pro forma	$ 0.75	$ 0.62

As noted above, we have several stockholder-approved stock incentive plans for employees and directors under which we have granted non-qualified stock options, restricted stock, and restricted stock units. We grant options under these plans at market value on the date of grant. The options generally vest over or at the end of four years. Options granted on or after August 24, 2005 expire seven years from the date of grant, while options granted before August 24, 2005 expire ten years from the date of grant. Restricted share awards generally vest at the end of four years. Certain option and restricted share awards provide for accelerated vesting upon a change in control or normal or early retirement (as defined in the plans). At August 31, 2006, we have reserved approximately 546,000 shares for future equity grants under our stock incentive plans.

As of August 31, 2006, there was $26.7 million of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the stock incentive plans. That cost is expected to be recognized over a weighted average period of 2.4 years.

Stock Options

In June 2005, we changed from the Black-Scholes option valuation model ("Black-Scholes model") to a lattice-based binomial option valuation model ("lattice binomial model"), which we consider preferable to the Black-Scholes model because the lattice binomial model considers characteristics of fair value option pricing, such as an option's contractual term and the probability of exercise before the end of the contractual term, that are not available under the Black-Scholes model. For the year ended August 31, 2006, we

Notes to Consolidated Financial Statements
Years Ended August 31, 2006, 2005 and 2004

contracted with a third party to assist in developing the assumptions, noted in the table below, used in estimating the fair values of stock options. During fiscal 2006, we based expected volatility on both historical volatility and implied volatility from traded options on the Company's stock. The expected term of options granted was derived from the output of the lattice binomial model and represents the period of time that options granted are expected to be outstanding. We used historical data to estimate expected option exercise and post-vesting employment termination behavior within the lattice binomial model.

For the years ended August 31, 2005 and 2004, we estimated the fair value of each option award on the date of grant using the Black-Scholes model. We based expected volatility on historical volatility. We estimated the expected term of stock options using historical exercise and employee termination experience.

The following table shows the weighted average grant-date fair values of options and the weighted average assumptions we used to develop the fair value estimates under each of the option valuation models for the years ended August 31, 2006, 2005, and 2004:

Year ended August 31,	2006	2005	2004
Weighted average grant-date fair value of options	$ 22.61	$ 20.02	$ 15.64
Assumptions:			
Expected volatility	47.7%	49.8%	60.0%
Expected dividends	–	–	–
Expected term (in years)	5.3	5.7	7.4
Risk-free rate	3.8%	3.8%	3.8%

A summary of option activity as of August 31, 2006 and changes during the year then ended is presented below:

Options	Shares (000s)	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value ($000s)
Outstanding at September 1, 2005	6,485	$ 16.53		
Granted	215	47.52		
Exercised	(782)	6.85		
Forfeited or expired	(82)	23.69		
Outstanding at August 31, 2006	5,836	18.87	6.3	$ 191,337
Exercisable at August 31, 2006	3,486	10.86	5.7	$ 142,076

The total intrinsic value, which represents the difference between the underlying stock's market price and the option's exercise price, of options exercised during fiscal 2006, 2005, and 2004 was $29.0 million, $29.8 million, and $25.4 million, respectively.

Cash received from option exercises under all share-based payment arrangements during fiscal 2006 and 2005 was $5.3 million and $4.6 million, respectively. The actual tax benefit realized for the tax deductions from option exercise of the share-based payment arrangements totaled $11.5 million and $11.8 million for the years ended August 31, 2006 and 2005, respectively. We issue new shares of common stock upon exercise of stock options.

Restricted Stock and Restricted Stock Units

The fair value of restricted stock and restricted stock units ("nonvested shares") is determined based on the closing bid price of the Company's common stock on the grant date. The weighted average grant-date fair value of nonvested shares granted during the years ended August 31, 2006 and 2005 was $47.40 and $42.51, respectively. Nonvested shares were not granted during the year ended August 31, 2004.

Notes to Consolidated Financial Statements
Years Ended August 31, 2006, 2005 and 2004

The following table shows a summary of our nonvested shares as of August 31, 2006 as well as activity during the year then ended. The total fair value of shares vested during fiscal 2006, 2005, and 2004 was $0.4 million, $16,000, and $40,000, respectively.

Nonvested Shares	Shares (000s)	Weighted Average Grant-Date Fair Value
Nonvested at September 1, 2005	135	$ 42.57
Granted	38	47.40
Vested	(10)	40.67
Forfeited	(3)	43.44
Nonvested at August 31, 2006	160	43.82

10. Comprehensive Income

Comprehensive income, net of income taxes, was $37.2 million, $33.0 million, and $26.1 million for the years ended August 31, 2006, 2005, and 2004, respectively.

11. Stockholder Rights Plan

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

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

12. Employee Benefits

We have a 401(k) Retirement Savings Plan (the "Plan") available to substantially all of our employees. Employees can contribute up to a certain percentage of their base compensation as defined in the Plan. The Company matching contributions are subject to vesting requirements. Company contributions under the Plan totaled $2.5 million, $2.3 million, and $2.0 million for the years ended August 31, 2006, 2005 and 2004, respectively.

13. Commitments and Contingencies

Pursuant to an earn-out agreement executed in connection with the acquisition of certain assets of Health IQ in June 2005, we are obligated to pay the former stockholders of Health IQ additional purchase price equal to a percentage of revenues recognized from Health IQ's programs in each of the fiscal quarters during the three-year period ending August 31, 2008.

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

Healthways, Inc. has since been dismissed as a defendant; however, the case is still pending against AHSI before the United States District Court for the District of Columbia. In addition, WPMC has settled claims filed against it as part of a larger settlement agreement that WPMC's parent organization, HCA Inc., reached with the United States government.

The complaint alleges that AHSI, the client hospitals and the medical directors violated the federal False Claims Act by entering into certain arrangements that allegedly violated the federal anti-kickback statute and

provisions of the Social Security Act prohibiting physician self-referrals. Although no specific monetary damage has been claimed, the plaintiff, on behalf of the federal government, seeks treble damages plus civil penalties and attorneys' fees. The plaintiff also has requested an award of 30% of any judgment plus expenses. In February 2006, WPMC filed an arbitration claim seeking indemnification from us for certain costs and expenses incurred by it in connection with the case.

In the action by the former employee, discovery is substantially complete but no trial date has been set. The parties have had initial discussions regarding their respective positions in the case; however, no resolution of this case has been reached or can be assured prior to the case proceeding to trial. In the action by WPMC, initial arbitration proceedings were commenced during the third quarter of fiscal 2006.

We believe that we have conducted our operations in full compliance with applicable statutory requirements and that we have meritorious defenses to the claims made in the case and the related arbitration proceeding, and intend to contest the claims vigorously. Nevertheless, it is possible that resolution of these legal matters could have a material adverse effect on our consolidated results of operations in a particular financial reporting period. We believe that we will continue to incur legal expenses associated with the defense of these matters which may be material to our consolidated results of operations in a particular financial reporting period. However, we believe that any resolution of this case and all related matters will not have a material effect on our liquidity or financial condition.

We are also subject to other claims and suits that arise from time to time in the ordinary course of our business. While management currently believes that resolving claims against us, individually or in aggregate, will not have a material adverse impact on our financial position, our results of operations, or our cash flows, these matters are subject to inherent uncertainties, and management's view of these matters may change in the future.

14. Segment Disclosures

SFAS No. 131, "Disclosures About Segments of an Enterprise and Related Information," establishes disclosure standards for segments of a company based on a management approach to defining operating segments. Through November 2003, we distinguished operating and reportable segments based upon the types of customers, hospitals or health plans, that contract for our services. In order to improve operational efficiency, in December 2003 we merged our operations into a single operating segment for purposes of presenting financial information and evaluating performance.

Our integrated Health and Care Support product line includes programs for various diseases, conditions, and wellness programs. It is impracticable for us to report revenues by program. Further, we report revenues from our external customers on a consolidated basis since Health and Care Support services are the only service that we provide.

We derived approximately 38% of our fiscal 2006 revenues from two contracts that each comprised more than 10% of our revenues for the year. Revenues from each of these contracts individually totaled approximately 27% and 11%, respectively, of fiscal 2006 revenues. In fiscal 2005 and 2004, these same two contracts each comprised more than 10% of revenues for the year, comprising in the aggregate approximately 38% and 44%, respectively, of our fiscal 2005 and fiscal 2004 revenues.

15. Subsequent Event

On September 30, 2006, we terminated an Agreement and Plan of Merger dated May 30, 2006 with LifeMasters Supported SelfCare, Inc. ("LifeMasters") and entered into a Merger Termination and Release Agreement which provides for, among other things, a mutual release of claims and a payment of $1.5 million from LifeMasters to reimburse us for certain of our expenses.

On October 11, 2006, we entered into a stock purchase agreement with Axia, a national provider of preventive health and wellness programs, to purchase all of Axia's outstanding shares of capital stock for approximately $450 million, subject to adjustment for Axia's indebtedness, working capital, and cash balance at closing. Of the purchase price, $35 million will be held in escrow until December 31, 2007 to satisfy any potential indemnification claims. An additional $9 million of the purchase price will be held in escrow to satisfy a portion of certain potential earnout obligations. We expect the acquisition to close during December 2006, subject to satisfaction of the closing conditions in the stock purchase agreement, including receipt of required regulatory approvals. We currently anticipate that the acquisition will be financed through a combination of cash on hand and committed bank debt.

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders of
Healthways, Inc. and Subsidiaries

We have audited the accompanying consolidated balance sheets of Healthways, Inc. and Subsidiaries (the Company) as of August 31, 2006 and 2005, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended August 31, 2006. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Healthways, Inc. and Subsidiaries at August 31, 2006 and 2005, and the consolidated results of their operations and their cash flows for each of the three years in the period ended August 31, 2006, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 1 and Note 9 to the consolidated financial statements, the Company adopted SFAS 123(R), *Share-Based Payment*, effective September 1, 2005.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Healthways, Inc. and Subsidiaries' internal control over financial reporting as of August 31, 2006, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated November 13, 2006 expressed an unqualified opinion thereon.

Nashville, Tennessee
November 13, 2006

Quarterly Financial Information (unaudited)

Fiscal 2006	First	Second	Third	Fourth
	(In thousands, except per share data)			
Revenues	$ 90,592	$ 100,021	$ 106,820	$ 114,876
Gross margin	$ 26,747	$ 29,162	$ 33,238	$ 42,000
Income before income taxes	$ 10,706	$ 12,161	$ 15,481	$ 22,811
Net income	$ 6,456	$ 7,333	$ 9,335	$ 14,027
Basic earnings per share [1]	$ 0.19	$ 0.21	$ 0.27	$ 0.41
Diluted earnings per share [1]	$ 0.18	$ 0.20	$ 0.26	$ 0.38

Fiscal 2005	First	Second	Third	Fourth
	(In thousands, except per share data)			
Revenues	$ 71,186	$ 75,337	$ 78,357	$ 87,624
Gross margin	$ 25,214	$ 27,205	$ 27,426	$ 27,406
Income before income taxes	$ 12,937	$ 13,953	$ 14,111	$ 13,793
Net income	$ 7,762	$ 8,441	$ 8,536	$ 8,344
Basic earnings per share [1]	$ 0.24	$ 0.26	$ 0.26	$ 0.25
Diluted earnings per share [1]	$ 0.22	$ 0.24	$ 0.24	$ 0.23

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

Reconciliation of Non-GAAP Measures to GAAP Measures (Unaudited)

Reconciliation of Core Commercial Diluted Earnings Per Share Excluding Long-Term Incentive Program Costs to Diluted Earnings Per Share (EPS), GAAP Basis

Year Ended August 31,	2006	2005	2004	2005 to 2006 % Chg.	2004 to 2005 % Chg.
Core commercial EPS, excluding long-term incentive compensation program costs[1]	$ 1.53	$ 1.03	$ 0.75	49%	37%
Less: EPS attributable to MHS pilots[2]	(0.20)	(0.10)	-		
Less: EPS attributable to international initiatives[3]	(0.05)	-	-		
Less: EPS attributable to long-term incentive compensation program costs[4]	(0.26)	-	-		
EPS, GAAP basis	$ 1.02	$ 0.93	$ 0.75		

[1] Core commercial EPS excluding long-term incentive compensation program costs is a non-GAAP financial measure. The Company excludes EPS attributable to MHS pilots, international initiatives, and long-term incentive compensation program costs from this measure and relies on core commercial EPS excluding long-term incentive compensation program costs because of its comparability to the Company's historical operating results. The Company believes it is useful to investors to provide disclosures of its operating results on the same basis as that used by management. You should not consider core commercial EPS excluding long-term incentive compensation program costs in isolation or as a substitute for EPS determined in accordance with accounting principles generally accepted in the United States.

[2] EPS attributable to MHS pilots in fiscal 2006 includes revenues and costs associated with the operation of the MHS pilots in Maryland and the District of Columbia and in Georgia. EPS attributable to MHS pilots in fiscal 2005 includes costs associated with the preparation and initial operation of the MHS pilots in Maryland and the District of Columbia and in Georgia.

[3] EPS attributable to international initiatives includes costs to implement the Company's strategy of establishing a presence in international markets.

[4] EPS attributable to long-term incentive compensation program costs includes costs of equity-based awards expensed under Statement of Financial Accounting Standards ("SFAS") No. 123(R) for fiscal year 2006 and cash-based awards issued in lieu of equity-based awards that were historically granted to certain levels of management. These cash-based awards are a result of changes in the design of the Company's long-term incentive compensation program in preparation for adopting SFAS No. 123(R) on September 1, 2005.

Reconciliation of Pro Forma Diluted EPS to Diluted EPS, GAAP Basis

Year Ended August 31,	2005
Pro forma EPS[5]	$ 0.75
EPS attributable to net pro forma effect of equity based compensation[6]	0.18
EPS, GAAP basis	$ 0.93

Fiscal 2006 EPS, GAAP basis	$ 1.02
Fiscal 2005 pro forma EPS[5]	$ 0.75
% change	36%

[5] Pro forma EPS is a non-GAAP financial measure. The Company includes the net pro forma effect of equity-based compensation in this measure and provides pro forma EPS because of its comparability to the Company's fiscal 2006 operating results. The Company believes it is useful to investors to provide disclosures of its operating results on the same basis as that used by management. You should not consider pro forma EPS in isolation or as a substitute for EPS determined in accordance with accounting principles generally accepted in the United States.

[6] EPS attributable to net pro forma impact of equity-based compensation includes the net effect on earnings per share as if the Company had applied the fair value recognition provisions of SFAS No. 123 to equity-based employee compensation during fiscal 2005.

Management's Annual Report on Internal Control over Financial Reporting

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

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

Management has performed an assessment of the effectiveness of the Company's internal control over financial reporting as of August 31, 2006 based on criteria established by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO"), Internal Controls - Integrated Framework, and believes that the COSO framework is a suitable framework for such an evaluation. Management has concluded that the Company's internal control over financial reporting was effective as of August 31, 2006.

Ernst & Young LLP, the independent registered public accounting firm that audited the Company's consolidated financial statements for the year ended August 31, 2006, has issued an attestation report on management's assessment of the Company's internal control over financial reporting which is included in this Annual Report to Stockholders.

We have performed an evaluation as of the end of the period covered by this report of the effectiveness of our "disclosure controls and procedures" (as defined in Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934), under the supervision and with the participation of our Chief Executive Officer and our Chief Financial Officer. Based upon our evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this report.

There have been no changes in our internal controls over financial reporting during the quarter ended August 31, 2006 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders of
Healthways, Inc. and Subsidiaries

We have audited management's assessment, included in the accompanying Management's Annual Report on Internal Control over Financial Reporting, that Healthways, Inc. and Subsidiaries maintained effective internal control over financial reporting as of August 31, 2006, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Healthways, Inc. and Subsidiaries' management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of 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, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, 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, management's assessment that Healthways, Inc. and Subsidiaries maintained effective internal control over financial reporting as of August 31, 2006 is fairly stated, in all material respects, based on the COSO criteria. Also, in our opinion, Healthways, Inc. and Subsidiaries maintained, in all material respects, effective internal control over financial reporting as of August 31, 2006, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Healthways, Inc. and Subsidiaries as of August 31, 2006, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended August 31, 2006 and our report dated November 13, 2006 expressed an unqualified opinion thereon.

Ernst & Young LLP

Nashville, Tennessee
November 13, 2006

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Ben R. Leedle, Jr.
President and Chief Executive Officer American Healthways, Inc.

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President and Chief Executive Officer

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Executive Vice President and Chief Financial Officer

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Executive Vice President and Chief Operating Officer

Robert E. Stone
Executive Vice President and Chief Strategy Officer

Mary D. Hunter
Executive Vice President

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Executive Vice President, Sales and Marketing

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Vanderbilt Page–Campbell Heart Institute
Division of Cardiology
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Assistant Professor of Medicine
Center for Health Services Research
Vanderbilt University Medical Center
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Director, Cardiac Services
Helen Hayes Hospital
West Haverstraw, New York

Janice M. Prochaska, Ph.D.
President and Chief Executive Officer
Pro-Change Behavior Systems, Inc.

Corporate Information

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FORM 10-K/INVESTOR CONTACT
A copy of the Healthways, Inc. 10-K Report for Fiscal 2006 (without exhibits) filed with the Securities and Exchange Commission is available on the Company's website, www.healthways.com. It is also available from the Company at no charge. These requests and other investor contacts should be directed to Mary A. Chaput, Executive Vice President and Chief Financial Officer at the Company's corporate office.

ANNUAL MEETING
The annual meeting of stockholders will be held on February 2, 2007, at 9:00 a.m. at the Marriott Hotel, 700 Cool Springs Blvd., Franklin, Tennessee.

COMMON STOCK AND DIVIDEND INFORMATION
The common stock of Healthways, Inc. is traded in The Nasdaq Stock Market under the symbol HWAY. At November 6, 2006, there were approximately 39,200 holders of the common stock, including 150 stockholders of record. No cash dividends have been paid on the common stock.

The following table sets forth the high and low sales prices per share of common stock as reported by NASDAQ for the relevant periods.

Year ended August 31, 2006	High	Low
First quarter	$ 46.77	$ 36.99
Second quarter	48.39	42.28
Third quarter	54.63	39.26
Fourth quarter	54.98	46.08

Year ended August 31, 2005	High	Low
First quarter	$ 34.42	$ 25.70
Second quarter	35.50	29.56
Third quarter	41.94	29.79
Fourth quarter	45.65	38.01

Healthways, A Journey of Innovation

1981

1981
Company founded

1982
Hospitals purchased and managed

1983
Drug and alcohol rehabilitation business launched

1984
Diabetes Treatment Centers of America (DTCA) forms and signs first contracts for hospital centers of excellence

1987
DTCA at Georgetown Hospital receives nation's first American Diabetes Association recognition of excellence

1991
Successful Initial Public Offering (Nasdaq: AMHC)

1992
American Healthcorp launches clinic-based surgery centers (Amsurg Corp.)

1994
Introduced Diabetes disease management program for health plans

1996
Signed first disease management contract with a healthplan

1998
Published first third-party validated outcomes

1999
- Launched Coronary Artery Disease program
- Launched Heart Failure program
- First call center opened in Nashville
- Changed name to American Healthways

2000

2000
- Launched Respiratory program for COPD and Asthma
- Signed first multiple-disease contract
- Established nation's first set of disease management standards

2001
- Launched Neural Net Predictive Modeling
- Acquired online CareSteps program
- Signed landmark 10-year contract with Blue Cross Blue Shield Minnesota
- Outcomes validated by Ernst & Young LLP
- Establishment of Johns Hopkins Outcomes Verification Program
- Received DMAA Comprehensive Disease Management Leadership Award

2002
- Launched Impact Conditions Program
- Launched sales support program for self insured employers
- Received Triple Crown Accreditation (JCAHO, URAC, NCQA)
- Received DMAA Comprehensive Disease Management Leadership Award

2003

2003
- Acquired StatusOne Health Systems
- No. 1 on *Fortune's* Fastest Growing Small Business List
- Named one of Nation's 'Hot Growth Companies' by *BusinessWeek*
- Over 1 million people in programs

2004

2004
- Ranked #1, Fastest-growing company, *Fortune Small Business*
- Ranked #1, Best Employer in Tennessee, *BusinessTN*
- Ranked among fastest-growing public companies, *BusinessWeek* & *Forbes*
- *Health Affairs* published landmark diabetes disease management outcomes study
- Awarded Medicare Health Support pilots

2005
- JCAHO, NCQA Privacy Certification for Business Associates program
- Acquired Health IQ Diagnostics—launching outcomes-driven wellness
- Launched Medicare Health Support pilots
- Repeat appearances, *FORTUNE, BusinessWeek* & *Forbes* fast-growth lists
- Received third DMAA Comprehensive Disease Management Leadership Award
- Partnered with Healthwise, Center for Information Therapy, Pro-Change Behavior Systems and the MIT AgeLab
- Launched international business development effort

2006
- Over 2 million people in programs
- Changed name to Healthways (Nasdaq: HWAY)
- Announced merger with Axia Health Management
- Repeat appearance on *Forbes* 200 Best Small Companies list
- Launched lifestyle management program
- Formed 10-year alliance with Medco
- 2006 Recipient of the DMAA Innovation In Unmet Health Needs Award

2006

25 years of innovation

2006 Recipient of the
Disease Management Association of America's
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