07 Annual Report

Transformation

Creating a
healthier world
one person at a time

HEALTHWAYS

Company Profile

Founded in 1981, Healthways (NASDAQ: HWAY) provides 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 provides services to approximately 27 million individuals in the United States and will launch its first international contract, in Germany, in fiscal 2008.

For the past quarter century, 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.

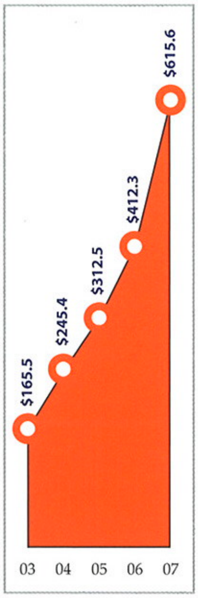
Predicated on the fundamental belief that healthier people cost less, Healthways' programs are designed to help keep healthy individuals healthy, mitigate and retard the progression to disease associated with family or lifestyle risk factors and promote the best possible health for those who are already affected by disease. We recognize that each individual plays a variety of roles in his or her pursuit of Health and Care Support, often at the same time. By providing, on a fully integrated basis, and either totally or in partnership with our customers, the full spectrum of Health and Care Support 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 health 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**.

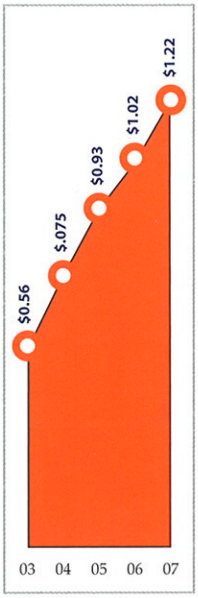
Financial Highlights

Year ended, and at August 31,	2007	2006
(In thousands, except per share and billed lives data)		
OPERATING DATA		
Revenues	$ 615,586	$ 412,308
Net income	$ 45,121	$ 37,151
Diluted earnings per share	$ 1.22	$ 1.02
Diluted weighted average common shares and equivalents	37,002	36,379
OPERATING STATISTICS		
Billed lives	27,446,000	2,426,000
FINANCIAL POSITION		
Cash and cash equivalents	$ 47,655	$ 154,792
Working capital	10,792	124,469
Total assets	828,845	382,386
Long-term debt	297,059	236
Other long-term liabilities	14,388	10,853
Stockholders' equity	362,750	274,873

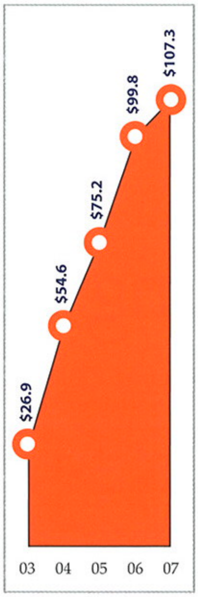
Revenue
(in millions)



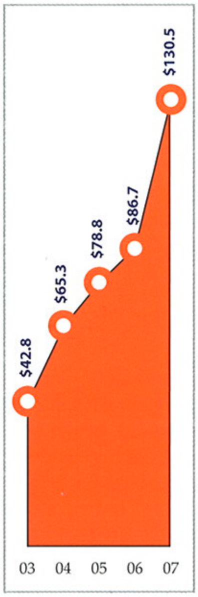
Diluted earnings per share [1]



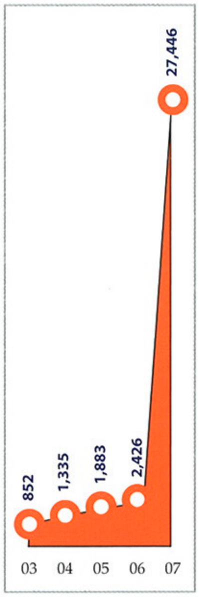
Cash flow from operations
(in millions)



EBITDA [2]
(in millions)



Billed Lives [3]
(in thousands)



(1) Restated to reflect the effect of the December 2003 two-for-one stock split.
(2) See page 44 for a reconciliation of GAAP and non-GAAP results.
(3) Restated to include the Company's hospital-based diabetes patients.

Fellow Stockholders:

A shared vision is the thread that knits an organization together, that harnesses its collective energies and talents toward a common goal. But, in our experience over two decades, it is the hard work of executing plans in pursuit of a vision that truly drives transformation.

Healthways' vision has long been based on our simple value proposition that by improving the health of a population, we can reduce its cost. Over the years, we have focused on maximizing the impact of our value proposition to improve health and, thereby, to reduce health-related costs by:

- keeping healthy people healthy;
- reducing lifestyle risk factors, like smoking or obesity, that left unchanged can lead to serious health conditions; and
- assuring optimization of care through best science for those with chronic diseases and intensive or persistent health conditions.

Our path to maximizing the impact of our value proposition has been to expand it to provide personal, customized solutions for every individual in any given population. As we continue to expand our value proposition to millions of people around the world, our vision is that we will transform how individuals, providers, employers, payors and policy makers think and act about health, thereby moving ever closer to our goal of creating a healthier, more productive world.

Healthways is driving this transformation today for approximately 27 million individuals worldwide, through more than 100 domestic and international health plans and through more than 800 major employer customers as we continue to execute on our plans for fulfilling our vision. Critical milestones in our steady progression since we first established the credibility of our value proposition have included our introduction of hospital-based diabetes treatment centers in 1984, the signing of our first diabetes disease management contract with a health plan in 1996, our signing of the industry's first multiple chronic disease management contract in 2000, and the development of and contracting for the provision of services for persistent conditions in 2001. In the last five years, we continued to drive market change through both acquisition and organic development of new chronic disease management programs, high-risk care management and our initial wellness programs. We also incorporated neural-net predictive modeling to ensure appropriate specificity of our interventions and industry leading behavior change techniques to ensure their effectiveness. Each of these milestones furthered transformation of health-related thought and behavior by either meaningfully expanding the participating population or by significantly enhancing our ability to affect the behavior change necessary to deliver on our value proposition.

During fiscal 2007, the momentum of our transformation increased at an unprecedented pace, driven principally by our December 2006 acquisition of Axia Health Management. By marrying the industry leaders in health support and care support solutions, we substantially expanded both the depth and breadth of our value proposition, enabling us to have a direct positive impact on the health and health-related costs of every person in any given population.

young & old

The best solutions in the world are of limited value if the individuals at whom they are aimed don't use them. To reach an entire population, young and old, healthy or living with a chronic condition, requires engaging each individual on a personalized basis. Every individual approaches his or her health differently. Program design, as well as the content and the methods of interacting – whether web self-service, chat, reminders via text messaging, print and telephonic support, or in-person assistance – need to drive participation and be specific to an individual's unique needs. Achieving maximum value requires activating and engaging every individual, which in turn, requires recognizing that each person's motivations to act and preference for the way in which they positively receive support, are as unique as they are.

Transforming engagement


Transforming
support

We are already focusing our capabilities to drive a further expansion of our value proposition. Again setting industry precedent, we are beginning to move the measure of the value we create beyond our impact on direct healthcare costs by introducing new credible methods to quantify the effect of health status on workforce performance and then demonstrating the impact of our comprehensive, differentiated services on reducing the costs associated with health-related productivity losses.

Our continuing development of these capabilities, when fully realized, will have created an order-of-magnitude increase in our value proposition. This initiative coincides with – and will meet the demand created by – escalating employer leadership and focus on solutions that will maximize the impact of the improved health of their employees and dependents on the productivity of their business. Five years ago, virtually all of our revenue was earned from health plan contracts for their fully insured members. In fiscal 2007, approximately one-third of our revenue was earned from employer contracts, either direct or through their health plans. While employers today recognize the medical cost savings benefits of disease management, they know they can have a much larger positive impact on their profitability through interventions that address the largely hidden and unmeasured impact of health-related absenteeism and presenteeism on productivity. As a result, we are already meaningfully engaged in discussions with employers who are demanding definitive, cause-and-effect solutions that lower the costs of lost productivity.

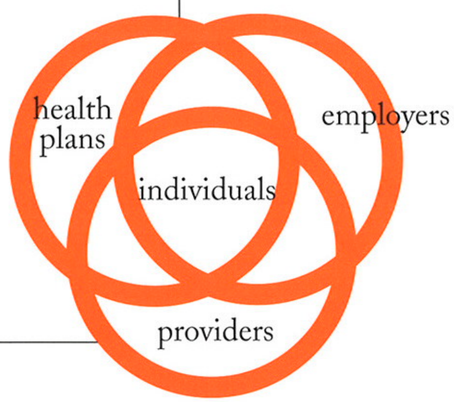
To quantify this opportunity, we developed, tested and validated a powerful simulation model designed to demonstrate the economic impact of providing our complete solution to an employer population. In a perfect state reflecting population health that is 100% optimized, the economic model projects savings that build to $13,400 annually per employee in the fifth year following implementation. Of this total, $6,000 in value accrues to the employee and his or her family, friends and community. The remaining $7,400 represents annual gross cost savings for the employer, with $5,400 produced by productivity gains and $2,000 by direct medical costs savings.

The model also indicates that our capabilities today, fully optimized, would enable us to produce roughly 12% of these potential savings, or about $900 per individual, in the fifth year following implementation, which would result in a shared-savings opportunity many times our average annual revenue per member for fiscal 2007. We believe our capacity to produce fully optimized savings at this level, at scale, is a truly unique and differentiating advantage in the industry today.

We intend to expand this advantage as we provide further solutions that narrow the health and savings gap between today's capabilities and that future perfect state, bringing us ever closer to achieving the total impact our model projects. The long-term growth opportunity represented by the expansion of the breadth of our value proposition, to include every individual, and its depth, to reflect the impact of health on productivity, is transforming our Company today. With effective execution, it has the power to transform our world.

working together...

Effective support must be specific to each individual's needs and available when needed, not when convenient to the delivery system. To provide that caliber of support requires fully integrated state-of-the-art solutions delivered by a broad spectrum of traditional and alternative healthcare providers, all aimed at helping each individual to achieve his or her greatest potential, irrespective of current health status. Our lifestyle management coaches, nurses, dietitians, pharmacists and alternative health providers employ the best evidence-based science and behavior-change methods in the world. Providing this breadth and depth of support will enable government, health plans, employers and providers to work together and will fundamentally change each individual's work and home environments as they relate to health. In turn, this coordinated effort will lead to new and powerful social networks that can be relied on to support the mutual goal of attaining the best health possible.



Transforming value

During fiscal 2007, the expansion in the breadth and depth of our value proposition was reflected both in the ten-fold increase in our billed lives and in meaningful additions to our addressable markets. Primarily as a result of the Axia acquisition, our billed lives increased to 27.4 million at the end of the fiscal year from 2.4 million at the end of fiscal 2006. In addition, our available lives expanded to 188.5 million from 76.9 million, of which we penetrated approximately 15% at the end of fiscal 2007, compared with 3% a year earlier. Our ability to expand the array of services we provide to our billed lives represents a significant long-term growth opportunity, as does our ability to increase penetration of our available lives.

We also continue to increase the number of our available lives as we add new addressable markets. For instance, available lives will increase by more than 6 million with the planned January 1, 2008 implementation of our first international contract, which we signed in August with Deutsche Angestellten Krankenkasse (DAK). The DAK contract adds Germany to our addressable markets and supports our ongoing conversations in a number of other international markets in Europe, South America and the Australasia region. Domestically, we remain fully committed to completing the Phase I Medicare Health Support pilot project, with a goal of adding Medicare's approximately 40 million beneficiaries as an addressable market, representing potential annual revenues of approximately $20 billion.

Because of opportunities inherent in expanding our value proposition and increasing our billed lives and addressable markets, we are confident that for fiscal 2008, we can further extend our record of seven consecutive years of significant profitable growth that we achieved with our results for fiscal 2007. Total revenues for fiscal 2007 increased 49% from 2006, reflecting the impact of the Axia acquisition. For fiscal 2008, we expect to record our first international revenues and to grow revenues from our domestic business at a more sustainable rate of 26% to 31%. We expect this growth to contribute to our anticipated 45% to 52% growth in our earnings per diluted share for fiscal 2008, up from 20% growth in earnings per diluted share for fiscal 2007.

Healthways produced cash flow from operations of $107 million for fiscal 2007, 2.4 times net income. This strong level of cash generation contributed to the reduction in our debt as a percentage of total capitalization to 45% at the end of the fiscal year from 51% at the end of the second quarter after we purchased Axia. Our EBITDA[1] (earnings before interest, taxes, depreciation and amortization) was $130.5 million for fiscal 2007, a 50% increase over fiscal 2006. With substantial continuing cash flow and with a ratio of year-end debt to EBITDA for fiscal 2007 of 2.3 times, Healthways remains well positioned to fund its anticipated growth for fiscal 2008.

Over the last five years, Healthways' focus on both our vision and the successful pursuit of meaningful expansions of our value proposition have fueled dramatic growth of both our footprint and stockholder value. Today, we provide our services to approximately 27 million people as compared to 579,000 at the end of 2002. That growth has contributed to an increase in the market value of our common stock to $49.80 per share at the end of fiscal 2007 from a split-adjusted $8.53 per share five years earlier. This growth simply would not have been possible without an organization filled with skilled, passionate and entrepreneurial individuals. We thank every one of our colleagues for their hard work, past and future. They have positioned Healthways to leverage the extraordinary opportunities for long-term growth we have described in this letter. We are confident that as we continue transforming healthcare to create a healthier world we will also create significant additional stockholder value.

Sincerely,

Ben R. Leedle, Jr.

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

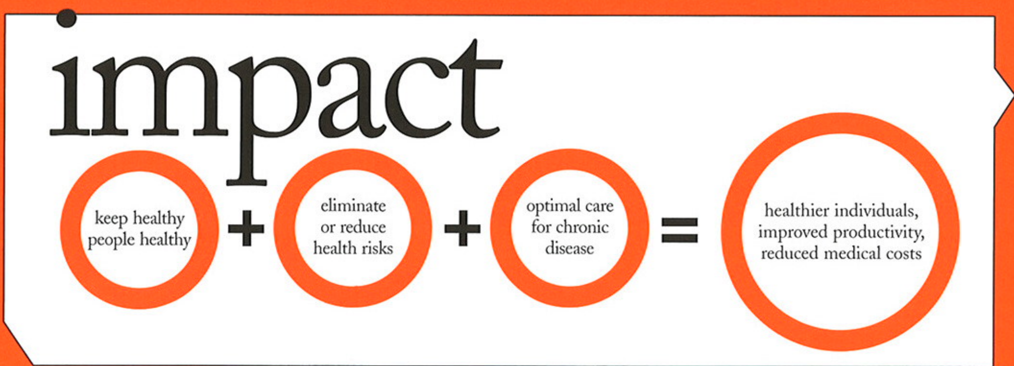
(1) See page 44 for a reconciliation of GAAP and non-GAAP results.

Strength in numbers

The real economic impact of poor health is the sum of the associated direct and indirect costs and the dollars that sponsors spend on health. By eliminating program silos and focusing on each individual's comprehensive health needs, we have expanded the population we can serve to include every individual. Further, since each individual's health has a direct impact on his or her productivity, as reflected in both absenteeism and presenteeism, we deliver solutions that address the needs not only of the sick, but also for those who are currently healthy or who are at risk for future health compromise. The ability of our solutions to impact both medical costs and lost productivity – and our ability to help those sponsors credibly measure that impact – enables our customers to know the business return on their health investments.

Arrest the cost

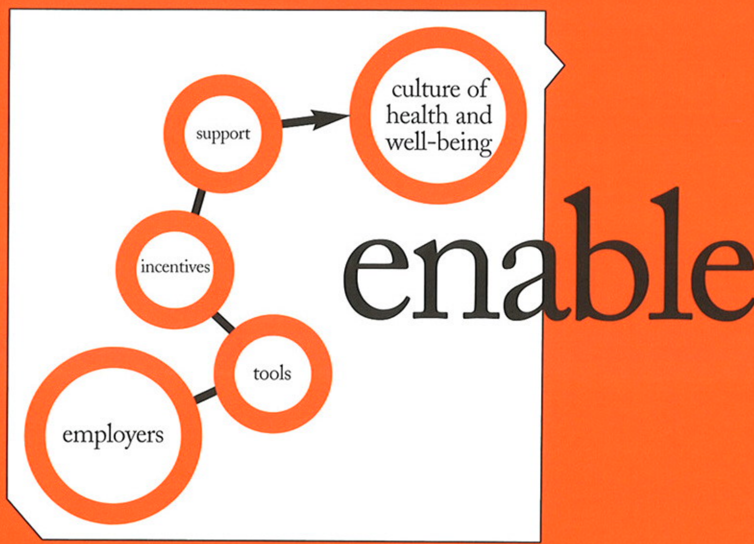
While disease and high-risk management programs continue to be a fundamental force in helping to curb the rapidly escalating medical costs associated with chronic disease and persistent conditions, they, alone, have not been enough to make healthcare affordable. Why? Because managing the high cost of individuals who are already sick impacts only those taxing the system today; it does not stem the tide of those who will develop persistent and chronic diseases tomorrow as a result of poor lifestyle choices such as smoking, lack of exercise and poor eating habits. Healthways made a commitment in 2005 to more deeply impact populations by providing services to identify individuals making poor health choices and to intervene before they develop a chronic disease. The formula for transformation is simple: keep healthy people healthy, eliminate or reduce health risks and optimize care. The result: healthier individuals, improved productivity, reduced medical costs and a true opportunity, for the first time, not just to bend the trend, but to truly arrest the cost.



Balance responsibility

Misaligned incentives, redundant services and disconnected data and providers are major drivers of rising healthcare costs. At Healthways, we believe the answer to better individual health and a more effective and efficient support system requires balanced responsibility among individuals, employers, health plans and providers, each of whom must be accountable for achieving positive health outcomes. Healthways actively supports these stakeholders to change the roles they play and aligns their activities toward a common focus on the outcome of health improvement.

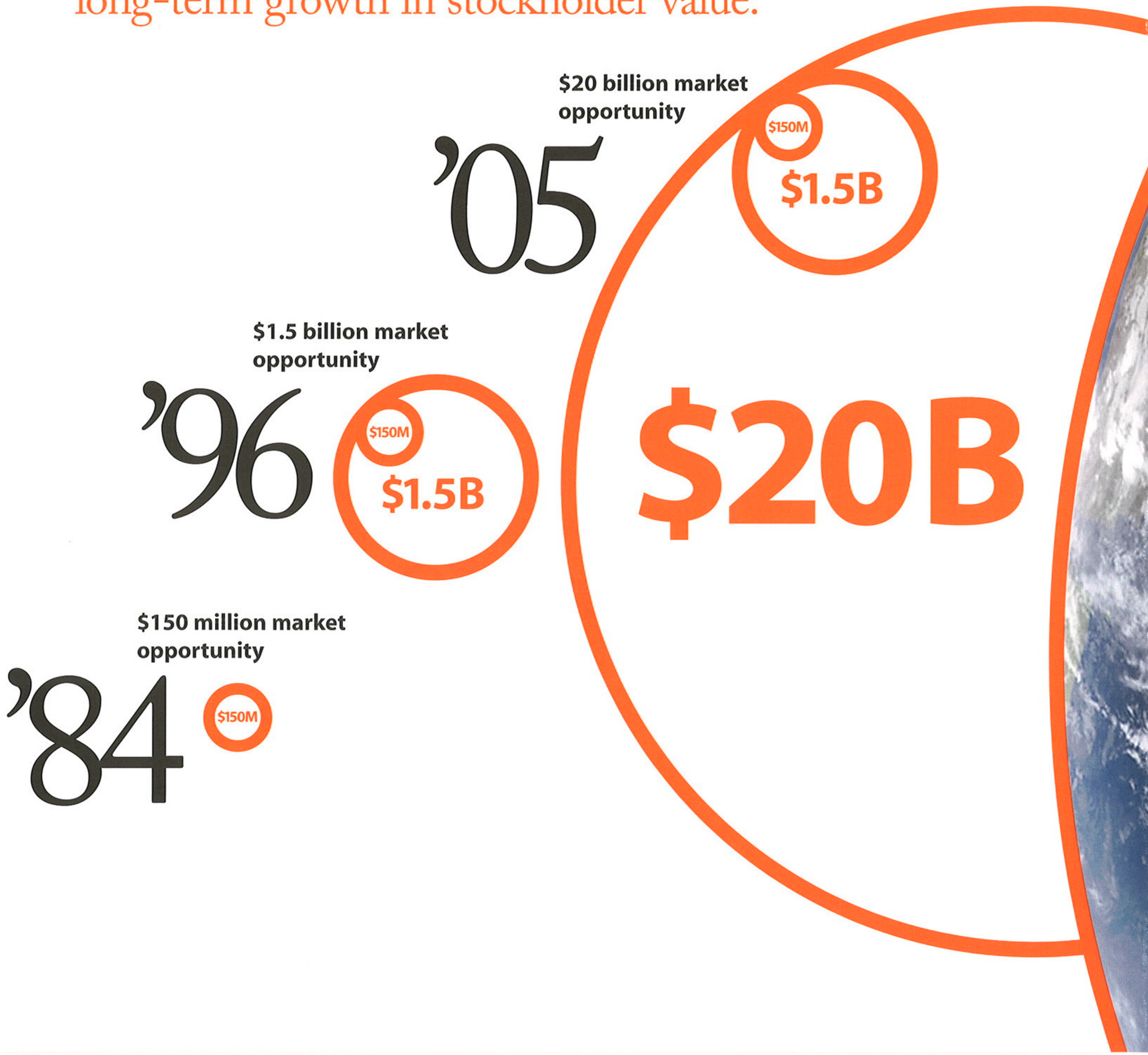
Our solutions create a critical nexus, connecting individuals, employers, health plans and providers for the optimal benefit of all. We provide the tools, incentives and support to enable individuals to take control of their health. We provide employers and health plans a comprehensive solution to the rising cost of healthcare. We provide employers with a roadmap for creating a culture of health and well-being for their employees. We support providers with a common view of aggregated data to assure they are all working toward the common goals of helping individuals take the appropriate preventive measures, change poor lifestyle habits and be responsible for their overall health. Roles and responsibilities for each stakeholder are transformed creating a system where appropriate balance is achieved and better health is attained.



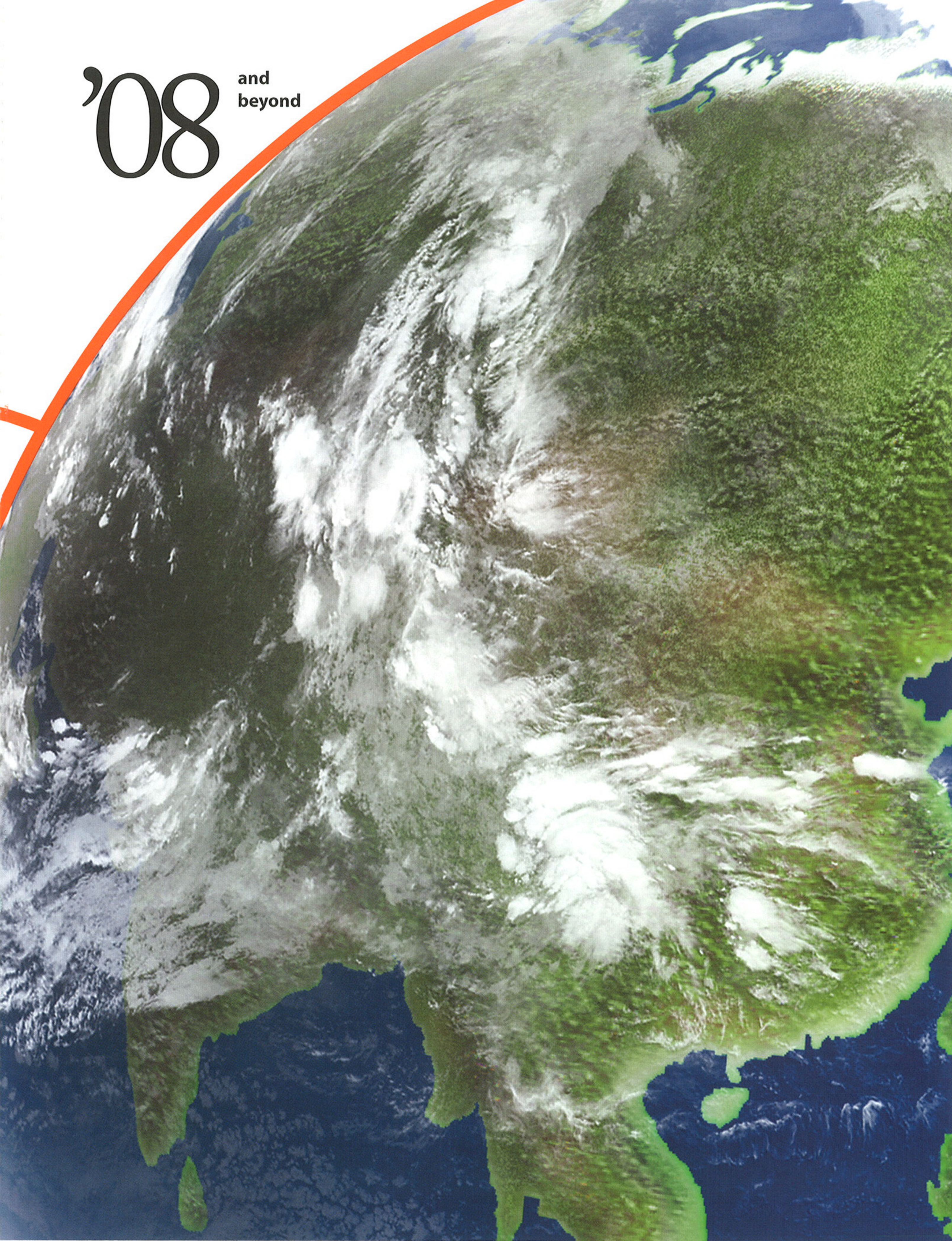
Create high performance

We believe that better health – defined as physical, mental and social well-being, not merely the absence of disease or infirmity – is a key contributor to high performance in business and in life. Accordingly, our goal is to help our customers transform their investment in health from a necessary cost into a true competitive advantage. Our approach for helping employers achieve and retain their competitive advantage is based on ensuring high-performing human capital by providing a comprehensive solution that impacts the entire population, produces additional savings related to productivity improvements and provides a significant return on investment.

Healthways has always met market need by providing value-driven solutions. These, in turn, have provided the basis for a dramatically increased value proposition, innovation leading to new solutions and an ever larger market opportunity. Our increasing penetration of this expanding market opportunity should assure significant long-term growth in stockholder value.



’08 and beyond



Directors and Executive Officers

Standing, left to right: C. Warren Neel, Ph.D.; J. Cris Bisgard, M.D., M.P.H.; Mary Jane England, M.D.; Thomas G. Cigarran; Ben R. Leedle, Jr.; Henry D. Herr
Seated: John A. Wickens; William C. O'Neil, Jr.; L. Ben Lytle; Alison Taunton - Rigby, Ph.D.; John W. Ballantine

Board of Directors

John W. Ballantine
Former Executive Vice President and Chief Risk Management Officer
First Chicago NBD Corporation

J. Cris Bisgard, M.D., M.P.H.
Former Director of Health Services
Delta Air Lines

Thomas G. Cigarran
Chairman and former Chief Executive Officer
Healthways, Inc.

Mary Jane England, M.D.
President of Regis College

Henry D. Herr
Former Executive Vice President and Chief Financial Officer
Healthways, Inc.

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

L. Ben Lytle
Former Chairman and Chief Executive Officer
Axia Health Management, LLC

C. Warren Neel, Ph.D.
Director of the Center for Corporate Governance
University of Tennessee

William C. O'Neil, Jr.
Former Chairman, President and Chief Executive Officer
ClinTrials Research, Inc.

Alison Taunton - Rigby, Ph.D.
Chief Executive Officer
RiboNovix, Inc.

John A. Wickens
Former National Health Plan President
UnitedHealth Group

Standing, left to right: Matthew Kelliher, Donald B. Taylor, Robert L. Chaput
Seated: Mary A. Chaput, Ben R. Leedle, Jr., James E. Pope, MD
Not pictured: Mary D. Hunter, Robert E. Stone

Executive Officers

Mary A. Chaput
Executive Vice President and Chief Financial Officer

Robert L. Chaput
Executive Vice President and Chief Information Officer

Mary D. Hunter
Executive Vice President

Matthew Kelliher
Executive Vice President, International Business

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

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

Robert E. Stone
Executive Vice President and Chief Strategy Officer

Donald B. Taylor
Executive Vice President, Sales and Marketing

Selected Financial Data

Year ended and at August 31, (In thousands, except per share data)	2007[4] [5] [6]	2006[4] [5]	2005[4]	2004[4]	2003
Operating Results: [1]					
Revenues	**$ 615,586**	$412,308	$312,504	$245,410	$165,471
Cost of services (exclusive of depreciation and amortization included below)	**417,721**	281,161	205,253	156,462	106,130
Selling, general and administrative expenses	**67,352**	44,417	28,418	23,686	16,511
Depreciation and amortization	**37,044**	24,517	22,408	18,450	10,950
Operating income	**93,469**	62,213	56,425	46,812	31,880
Interest expense	**18,185**	1,053	1,630	3,509	569
Income before income taxes	**75,284**	61,160	54,795	43,303	31,311
Income tax expense	**30,163**	24,009	21,711	17,245	12,837
Net income	**$ 45,121**	$ 37,151	$ 33,084	$ 26,058	$ 18,474
Basic income per share: [2]	**$ 1.29**	$ 1.08	$ 1.00	$ 0.81	$ 0.60
Diluted income per share: [2]	**$ 1.22**	$ 1.02	$ 0.93	$ 0.75	$ 0.56
Weighted average common shares and equivalents: [2]					
Basic	**35,049**	34,348	33,241	32,264	31,048
Diluted	**37,002**	36,379	35,691	34,632	33,010
Balance Sheet Data: [1]					
Cash and cash equivalents	**$ 47,655**	$154,792	$ 63,467	$ 45,147	$ 35,956
Working capital	**10,792**	124,469	70,644	55,462	47,047
Total assets	**828,845**	382,386	270,954	253,449	140,013
Long-term debt	**297,059**	236	416	36,562	109
Other long-term liabilities	**14,388**	10,853	9,055	7,694	4,662
Stockholders' equity	**362,750**	274,873	206,930	155,435	112,431
Other Operating Data:					
Billed lives [3]	**27,446**	2,426	1,883	1,335	852
Annualized revenue in backlog	**$ 39,900**	$ 6,625	$ 32,578	$ 15,200	$ 12,200

(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 Health Systems, LLC since the date of the acquisition, which was September 5, 2003.

(5) Includes $21.0 million in fiscal 2007 and $15.3 million in fiscal 2006 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.

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

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

Overview

Founded in 1981, Healthways, Inc. (the "Company") provides 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 services are made available to consumers by phone, mail, internet, and face-to-face interactions. To expand our Health Support offerings, on December 1, 2006 we acquired Axia Health Management, Inc. ("Axia"), a national provider of preventive health and wellness programs, for approximately $467.0 million in cash.

We deliver our programs to customers, which include health plans, governments, employers, and hospitals, in all 50 states, the District of Columbia, Puerto Rico, and Guam. These services include:

- fostering wellness and disease prevention through total population screening, health risk assessments, and supportive interventions;
- providing access to health improvement programs such as fitness, weight management, complementary and alternative medicine and smoking cessation;
- promoting the reduction of lifestyle behaviors that lead to poor health or chronic conditions;
- providing educational materials and personal interactions with highly trained nurses and other healthcare professionals that are designed to create and sustain healthier behaviors to members with chronic conditions;
- incorporating current evidence-based clinical guidelines into interventions to optimize patient health outcomes;
- developing Care Support plans and motivating members to set attainable goals for themselves;
- providing local market resources to address acute episodic interventions; and
- coordinating members' care with local healthcare providers.

Our programs focus on prevention, education, physical fitness, health coaching, behavior change and evidence-based medicine to drive adherence to proven standards of care, medications and physicians' plans of care. The programs are designed to support better health and assist in providing more effective care, which we believe will optimize the health status of member populations and reduce both the short-term and long-term healthcare costs for members.

Health and Care Support services enable health plans and employers to reach and engage everyone in their covered populations through interventions that are both sensitive to and specific to each individual's health risks and needs. Health Support products are designed to motivate people to make positive lifestyle changes and accomplish individual goals, such as becoming more physically active through the Healthways SilverSneakers® Fitness Program, staying fit using on-line tools and a vast network of fitness centers, and quitting smoking through an on-line smoking cessation community, QuitNet®. The Care Support product line includes programs for people with chronic diseases or conditions, including diabetes, coronary artery disease, heart failure, asthma, chronic obstructive pulmonary disease, end-stage renal disease, cancer, chronic kidney disease, depression, high-risk obesity, metabolic syndrome, 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 through our StatusOne® product for members at risk for hospitalization due to complex conditions. We believe that creating real and sustainable behavior change generates measurable long-term cost savings.

Predicated on the fundamental belief that healthier people cost less, Healthways' programs are designed to help keep healthy individuals healthy, mitigate and delay 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 his or her pursuit of health, often simultaneously. By providing the full spectrum of Health and Care Support services to meet each individual's needs, we believe 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 access to the significant number of individuals who seek health services outside of the traditional healthcare system.

We continue to see 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 available and billed lives or annualized revenue in backlog, as appropriate.

Highlights of Fiscal 2007 Performance

- On December 1, 2006 we acquired Axia, a national provider of preventive health and wellness programs, to expand our Health Support offerings.
- Revenues increased 49.3% over fiscal 2006.
- Net income increased 21.5% over fiscal 2006.
- Available lives and billed lives increased to 188.5 million and 27.4 million, respectively, at August 31, 2007 compared to 76.9 million and 2.4 million, respectively, at August 31, 2006.

Recent Developments

In August 2007, we signed our first international contract with a statutory health insurance company in Germany to provide Health and Care Support solutions for a portion of its members with chronic diseases.

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 and/or our cooperative agreement with the Centers for Medicare & Medicaid Services ("CMS") ahead of data collection and reconciliation in order to provide forward-looking guidance;
- the effect of any new or proposed legislation, regulations and interpretations relating to the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, including the potential expansion to Phase II for Medicare Health Support ("MHS") programs;
- our ability to effect the financial, clinical, and satisfaction outcomes under our cooperative agreement with CMS and reach mutual agreement with CMS with respect to results necessary to achieve success under Phase I of the MHS pilots;
- our ability to anticipate the rate of market acceptance of Health and Care Support solutions;
- the impact of individual market dynamics in potential international markets on our ability to sign an international contract within the timeframes contemplated by us and our ability to accurately forecast the costs necessary to implement our strategy of establishing a presence in these markets;
- the risks associated with foreign currency exchange rate fluctuations and our ability to hedge against such fluctuations;
- the potential adverse effects of additional regulatory requirements imposed by foreign governments and other regulatory bodies;
- 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;

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

- our ability to favorably resolve contract billing and interpretation issues with our customers;
- increased leverage incurred in conjunction with the acquisition of Axia and our ability to service our debt and make principal and interest payments as those payments become due;
- 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 typically set the PMPM rates during contract negotiations with customers based on the value we expect our programs to create and a sharing of that value between the customer and the Company. In some contracts, the PMPM rates may differ between a customer's lines of business (e.g., PPO, HMO, Medicare Advantage). In addition, some of our services are billed on a fee for service basis.

Some of our contracts provide that a portion (up to 100%) of our fees may be refundable to the customer ("performance-based") if our programs do not achieve, when compared to a baseline year, a targeted percentage reduction in the customer's healthcare costs and selected clinical and/or other criteria that focus on improving the health of the members. Approximately 4% of revenues recorded during fiscal 2007 were performance-based and were subject to final reconciliation as of August 31, 2007. We anticipate that this percentage will fluctuate due to the level of performance-based fees in new contracts, revenue recognition associated with performance-based

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

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

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

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

Substantially all of the fees under the MHS pilots 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 5.0%. 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 5.0% at the end of the pilots. Under the amendment to our agreement for our stand-alone MHS pilot in Maryland and the District of Columbia, the refresh population, which we began serving on August 1, 2006, 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. 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 summary 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 healthcare claims and clinical data. As of August 31, 2007, performance-based fees that have not yet been settled with our customers but that have been recognized as revenue in the current and prior years totaled approximately $43.0 million. Of this amount, $8.5 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 $34.5 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 2007, we recognized a net decrease in revenue of $2.2 million that related to services provided prior to fiscal 2007.

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

Impairment of Intangible Assets and Goodwill

In accordance with 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 certain 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

In accordance with SFAS No. 123(R), "Share-Based Payment," we measure and recognize compensation expense for all share-based payment awards based on estimated fair values at the date of grant. Determining the fair value of share-based awards at the grant date requires judgment in developing assumptions, which involve a number of variables. These variables include, but are not limited to, the expected stock price volatility over the term of the awards, and expected stock option exercise behavior. In addition, we also use judgment in estimating the number of share-based awards that are expected to be forfeited. 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 optimize the health of entire populations as well as the quality and affordability of healthcare through our Health and Care Support programs and services both domestically and internationally, thereby creating value for health plans, governments, employers, and hospitals. We plan to continue using our scalable state-of-the-art care enhancement centers, medical information content, web services, health provider networks 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 reach and provide support to entire populations. The flexibility of our programs allows customers to enter the Health and Care Support market at the level of services that they deem appropriate for their organization. Customers may select from a single prevention program or chronic disease to a total-population approach, in which all members of the customer's population receive the benefit of our programs.

We deliver programs that engage consumers in their health. We believe that we can achieve health improvements and generate significant cost savings by addressing consumer and customer needs for effective programs that support the individual across his or her lifetime.

We anticipate that we will incur significant costs during fiscal 2008 to enhance and expand our Health and Care Support capabilities, pursue opportunities in international markets, enhance our information technology support, integrate the operations of Axia, and open additional or expand current capacity 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 or investments.

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

Results of Operations

The following table shows the components of the statements of operations for the fiscal years ended August 31, 2007, 2006 and 2005 expressed as a percentage of revenues.

Year ended August 31,	2007	2006	2005
Revenues	**100.0%**	100.0%	100.0%
Cost of services (exclusive of depreciation and amortization included below)	**67.9%**	68.2%	65.7%
Selling, general and administrative expenses	**10.9%**	10.8%	9.1%
Depreciation and amortization	**6.0%**	5.9%	7.2%
Operating income[1]	**15.2%**	15.1%	18.1%
Interest expense	**3.0%**	0.3%	0.5%
Income before income taxes[1]	**12.2%**	14.8%	17.5%
Income tax expense	**4.9%**	5.8%	6.9%
Net income[1]	**7.3%**	9.0%	10.6%

[1] Figures may not add due to rounding.

Revenues

Revenues for fiscal 2007 and fiscal 2006 increased 49.3% and 31.9%, respectively, over the prior fiscal years. Fiscal 2007 revenues increased over fiscal 2006 revenues primarily due to the following:

- revenues of $136.5 million attributable to the acquisition of Axia on December 1, 2006;
- an increase in the number of self-insured employer billed lives for Care Support programs on behalf of our health plan customers from 954,000 at August 31, 2006 to 1,633,000 at August 31, 2007;
- the addition of new Care Support programs or expansion of existing programs into additional populations with eight existing customers since the beginning of fiscal 2006; and
- the commencement of ten new Care Support contracts since the beginning of fiscal 2006.

These increases were slightly offset by decreases in fiscal 2007 revenues compared to fiscal 2006 due to the following:

- contract terminations with certain customers, the largest of which we began providing services to again on October 1, 2007; and
- decreased revenues associated with the MHS pilots. Due primarily to an increasing cumulative net savings target over the term of the pilots, during fiscal 2007 cumulative savings fell below the cumulative net savings target, resulting in a reversal of $4.4 million in performance-based revenues.

Fiscal 2006 revenues increased over fiscal 2005 revenues primarily due to the following:

- the addition of new Care Support programs or expansion of existing programs into additional populations with nine existing customers since the beginning of fiscal 2005;
- an increase in the number of self-insured employer billed lives for Care Support programs on behalf of our health plan customers from 641,000 at August 31, 2005 to 954,000 at August 31, 2006;
- the commencement of nine 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.

We anticipate that fiscal 2008 revenues will increase over fiscal 2007 revenues primarily due to the expansion of existing contracts, increasing demand for our Health and Care Support services from self-insured employers, anticipated new contracts, a full year of revenues associated with Axia, and contracts signed during fiscal 2007 which have not yet started.

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

Cost of Services

Cost of services (excluding depreciation and amortization) as a percentage of revenues decreased to 67.9% for fiscal 2007 compared to 68.2% for fiscal 2006. The decrease is primarily due to the following:

- a decrease in the level of employee bonus provision due to the Company not meeting its internal incentive targets; and
- a decrease in professional consulting fees related to information technology initiatives.

These decreases were partially offset by increases in cost of services as a percentage of revenues for fiscal 2007 compared to fiscal 2006 related to the following:

- increased costs related to the MHS pilots, primarily due to 1) additional costs related to the timing of the pilot in Georgia in collaboration with CIGNA, which we began serving during the first quarter of fiscal 2006; 2) enhanced interventions to focus on the special needs of this population; and 3) additional costs related to the refresh population, which we began serving on August 1, 2006;
- the acquisition of Axia, which has somewhat higher cost of services as a percentage of revenues due to the nature of Health Support services, as well as the related integration costs; and
- an increase in salary and benefit expense, primarily related to organizational design changes in our field support and operations structure.

Cost of services (excluding depreciation and amortization) 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 as we have not achieved the cumulative net savings targets. 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.

We anticipate that fiscal 2008 cost of services will increase over fiscal 2007 primarily as a result of expenses associated with opening additional care enhancement centers and 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, an increase in the level of the employee bonus provision, and a full year of cost of services attributable to Axia, including related operational integration expenses.

Selling, General and Administrative Expenses

Selling, general and administrative expenses as a percentage of revenues increased to 10.9% for fiscal 2007 compared to 10.8% for fiscal 2006, primarily due to the following:

- an increase in salaries and benefits related to changes in our infrastructure to support anticipated future growth;
- an increase in professional consulting fees related to certain strategic initiatives; and
- integration costs related to the acquisition of Axia.

These increases were somewhat offset by a decrease in selling, general and administrative expenses as a percentage of revenues for fiscal 2007 compared to fiscal 2006 related to the following:

- a decrease in the level of employee bonus provision due to the Company not meeting its internal incentive targets; and
- the acquisition of Axia, which had somewhat lower selling, general and administrative expenses as a percentage of revenues due to the nature of Health Support services.

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

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.

We anticipate that selling, general and administrative expenses for fiscal 2008 will increase over fiscal 2007 primarily due to anticipated investments in international initiatives, increases in selling and general administrative costs in support of our existing and anticipated new and expanded contracts, an increase in the level of the employee bonus provision, costs related to relocating our corporate headquarters, a full year of 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 2007 increased 51.1% compared to fiscal 2006, primarily due to the following:

- depreciation and amortization expense associated with the depreciable assets and preliminary identifiable intangible assets recorded in connection with the Axia acquisition on December 1, 2006; and
- increased depreciation expense associated with capital expenditures to enhance our information technology capabilities, to relocate our Phoenix care enhancement center, and expand our calling capacity at existing care enhancement centers.

Depreciation and amortization expense for fiscal 2006 increased 9.4% compared to fiscal 2005, 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 2008 will increase over fiscal 2007 primarily as a result of 1) a full year of depreciation and amortization expense associated with depreciable assets and identifiable intangible assets recorded in connection with acquisitions during fiscal 2007, 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 2007 increased \$17.1 million compared to fiscal 2006, primarily due to borrowings under the Third Amended and Restated Revolving Credit and Term Loan Agreement (the "Third Amended Credit Agreement") related to the acquisition of Axia on December 1, 2006.

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

We anticipate that interest expense for fiscal 2008 will increase over fiscal 2007 primarily as a result of a full year of interest expense related to borrowings under the Third Amended Credit Agreement related to the Axia acquisition.

Income Tax Expense

Our effective tax rate increased to 40.1% for fiscal 2007 compared to 39.3% for fiscal 2006, primarily due to the lack of tax benefit on certain expenses incurred in international initiatives, somewhat offset by a reduction in our average state income tax rate, which is impacted by our geographic mix of earnings. The differences between the statutory federal income tax rate of 35.0% and our effective tax rate are due primarily to the impact of state income taxes, the lack of tax benefit on certain expenses incurred in international initiatives, and certain non-deductible expenses for income tax purposes.

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

Our effective tax rate decreased to 39.3% for fiscal 2006 compared to 39.6% for fiscal 2005, primarily as a result of a reduction in our average state income tax rate, which is impacted by changes in our geographic mix of earnings, 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 2008 will not change significantly from fiscal 2007; however, we continue to evaluate the impact of the Axia acquisition on our geographic mix of earnings and overall state tax rate.

Liquidity and Capital Resources

Cash and cash equivalents decreased $107.1 million during fiscal 2007 to $47.7 million at August 31, 2007 from $154.8 million at August 31, 2006. The decrease was primarily due to the acquisition of Axia, which was funded through the use of approximately $117.0 million in available cash and $350.0 million in borrowings.

Operating activities for fiscal 2007 generated cash of $107.3 million compared to $99.8 million for fiscal 2006. The increase in operating cash flow resulted primarily from the following:

- an increase in net income;
- improved cash collections on accounts receivable; and
- an increase in cash collections recorded to contract billings in excess of earned revenue, primarily related to the MHS pilots.

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

- an increase in income tax payments, primarily due to increased payments of taxes that were accrued at the end of the previous fiscal year as well as overpayments on current period taxes;
- increased payments of employee bonuses that were accrued at the end of the previous fiscal year; and
- a decrease in days payables outstanding (excluding non-trade expenses such as salaries and benefits and integration) from 39 days at August 31, 2006 to 26 days at August 31, 2007.

Investing activities during fiscal 2007 used $531.6 million in cash and consisted primarily of payments related to the acquisition of Axia on December 1, 2006, purchases of property and equipment, and other investments and acquisitions.

Financing activities during fiscal 2007 provided $317.2 million in cash primarily from the proceeds of borrowings under the Third Amended Credit Agreement of $350.0 million, offset by payments of $51.2 million on these borrowings.

On December 1, 2006, we entered into the Third Amended Credit Agreement. The Third Amended Credit Agreement provides us with a $400.0 million revolving credit facility, including a swingline sub facility of $10.0 million and a $75.0 million sub facility for letters of credit, a $200.0 million term loan facility, and an uncommitted incremental accordion facility of $200.0 million. As of August 31, 2007, availability under our revolving credit facility totaled $298.9 million.

Revolving advances under the Third Amended Credit Agreement generally bear interest, at our option, at 1) LIBOR plus a spread of 0.875% to 1.750% or 2) the greater of the federal funds rate plus 0.5%, or the prime rate, plus a spread of 0.000% to 0.250%. In February 2007, we amended the Third Amended Credit Agreement such that term loan borrowings generally bear interest, at our option, at 1) LIBOR plus 1.50% or 2) the greater of the federal funds rate plus 0.5%, or the prime rate. The Third Amended Credit Agreement also provides for a fee ranging between 0.150% and 0.300% of unused commitments. The Third Amended Credit Agreement is secured by guarantees from most of the Company's domestic subsidiaries and by security interests in substantially all of the Company's and such subsidiaries' assets.

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

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

The Third 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. The Third Amended Credit Agreement also restricts the payment of dividends and limits the amount of repurchases of the Company's common stock. As of August 31, 2007, we were in compliance with all of the covenant requirements of the Third Amended Credit Agreement.

On December 21, 2006, we entered into an amortizing fixed interest rate swap agreement for the management of interest rate exposure. By entering into this interest rate swap agreement, we effectively converted \$230.0 million of floating rate debt to a fixed obligation with an interest rate of 4.995%. The principal value of the swap arrangement amortizes over a 39-month period and terminates on March 31, 2010. We currently believe that we meet the hedge accounting criteria under SFAS No. 133 in accounting for the interest rate swap agreement.

We believe that cash flows from operating activities, our available cash, and our expected available credit under the Third Amended Credit Agreement will continue to enable us to meet our contractual obligations and to fund 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.

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.

In July 2007, our Board of Directors authorized a share repurchase program which allows for the repurchase of up to \$100 million of our common stock from time to time in the open market or in privately negotiated transactions through July 5, 2009.

Contractual Obligations

The following schedule summarizes our contractual cash obligations by the indicated period as of August 31, 2007:

	Payments Due By Year Ended August 31,				
	2008	2009 - 2010	2011 - 2012	2013 and After	Total
(In \$000s)					
Capital lease obligations	\$ 229	\$ 60	\$ –	\$ –	\$ 289
Deferred compensation plan payments	1,861	1,915	577	5,107	9,460
Long-term debt[1]	23,489	40,723	141,121	205,685	411,018
Operating lease obligations[2]	12,766	24,345	20,700	66,693	124,504
Purchase obligations	1,357	–	–	–	1,357
Other contractual cash obligations[3]	2,400	3,175	–	–	5,575
Total contractual cash obligations	\$ 42,102	\$ 70,218	\$162,398	\$277,485	\$552,203

[1] Includes scheduled principal payments, repayment of outstanding revolving loans, and estimated interest payments on outstanding borrowings under the Third Amended Credit Agreement.

[2] 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 by March 1, 2008.

[3] 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.

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

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. The adoption of FIN No. 48 on September 1, 2007 is not expected to have a material effect 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.

Fair Value Option for Financial Assets and Financial Liabilities

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115." SFAS No. 159 provides entities with the one-time option to measure financial instruments and certain other items at fair value, with changes in fair value recognized in earnings as they occur. The fair value option may be applied instrument by instrument (with a few exceptions), is irrevocable, and must be applied to entire instruments and not to portions of an instrument. SFAS No. 159 is effective for financial statements issued for fiscal years beginning after November 15, 2007. We have not yet completed our analysis of the impact that the implementation of SFAS No. 159 will have on our results of operations or financial condition.

Quantitative and Qualitative Disclosures About Market Risk

We are subject to market risk related to interest rate changes, primarily as a result of the Third Amended Credit Agreement, which bears interest based on floating rates. Revolving advances under the Third Amended Credit Agreement generally bear interest, at our option, at 1) LIBOR plus a spread of 0.875% to 1.750% or 2) the greater of the federal funds rate plus 0.5%, or the prime rate, plus a spread of 0.000% to 0.250%. In February 2007, we amended the Third Amended Credit Agreement such that term loan borrowings generally bear interest, at our option, at 1) LIBOR plus 1.50% or 2) the greater of the federal funds rate plus 0.5%, or the prime rate.

In order to manage our interest rate exposure under the Third Amended Credit Agreement, we entered into an amortizing fixed interest rate swap agreement in December 2006, effectively converting $230.0 million of floating rate debt to a fixed obligation with an interest rate of 4.995%.

A one-point interest rate change would have resulted in interest expense fluctuating approximately $0.9 million for fiscal 2007.

As of August 31, 2007, as a result of our investment in international initiatives, we are also exposed to foreign currency exchange rate risks. Because a significant portion of these risks is economically hedged with currency options and forwards contracts and because our international initiatives are not yet material to our consolidated results of operations, a 10% change in foreign currency exchange rates would not have had a material impact on our results of operations or financial position for fiscal 2007. We do not execute transactions or hold derivative financial instruments for trading purposes.

Consolidated Balance Sheets

At August 31, (In thousands, except share and per share data)	2007	2006
Assets		
Current assets:		
Cash and cash equivalents	$ 47,655	$ 154,792
Accounts receivable, net	80,201	52,978
Prepaid expenses	10,370	7,288
Other current assets	4,319	2,109
Income taxes receivable	1,741	–
Deferred tax asset	7,145	3,726
Total current assets	151,431	220,893
Property and equipment:		
Leasehold improvements	19,268	15,693
Computer equipment and related software	87,843	70,524
Furniture and office equipment	20,435	18,533
Capital projects in process	12,336	5,325
	139,882	110,075
Less accumulated depreciation	(81,160)	(63,525)
	58,722	46,550
Long-term deferred tax asset	–	2,557
Other assets	15,609	4,052
Customer contracts, net	41,777	3,660
Other intangible assets, net	77,722	8,539
Goodwill, net	483,584	96,135
Total assets	$ 828,845	$ 382,386
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$ 13,630	$ 9,221
Accrued salaries and benefits	18,960	36,007
Accrued liabilities	22,146	5,429
Deferred revenue	7,918	319
Contract billings in excess of earned revenue	72,829	35,013
Income taxes payable	–	7,906
Current portion of long-term debt	2,213	180
Current portion of long-term liabilities	2,943	2,349
Total current liabilities	140,639	96,424
Long-term debt	297,059	236
Long-term deferred tax liability	14,009	–
Other long-term liabilities	14,388	10,853
Stockholders' equity:		
Preferred stock $.001 par value, 5,000,000 shares authorized, none outstanding	–	–
Common stock $.001 par value, 75,000,000 shares authorized, 35,606,482 and 34,597,748 shares outstanding	35	35
Additional paid-in capital	188,126	140,200
Retained earnings	174,641	134,622
Accumulated other comprehensive income (loss)	(52)	16
Total stockholders' equity	362,750	274,873
Total liabilities and stockholders' equity	$ 828,845	$ 382,386

See accompanying notes to the consolidated financial statements.

Consolidated Statements of Operations

Year ended August 31,	2007	2006	2005
(In thousands, except earnings per share data)			
Revenues	**$ 615,586**	$ 412,308	$ 312,504
Cost of services (exclusive of depreciation and amortization of $27,677, $19,948, and $18,590, respectively, included below)	**417,721**	281,161	205,253
Selling, general and administrative expenses	**67,352**	44,417	28,418
Depreciation and amortization	**37,044**	24,517	22,408
Operating income	**93,469**	62,213	56,425
Interest expense	**18,185**	1,053	1,630
Income before income taxes	**75,284**	61,160	54,795
Income tax expense	**30,163**	24,009	21,711
Net income	**$ 45,121**	$ 37,151	$ 33,084
Earnings per share:			
Basic	**$ 1.29**	$ 1.08	$ 1.00
Diluted	**$ 1.22**	$ 1.02	$ 0.93
Weighted average common shares and equivalents			
Basic	**35,049**	34,348	33,241
Diluted	**37,002**	36,379	35,691

See accompanying notes to the consolidated financial statements.

Consolidated Statement 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, 2004	$ –	$ 33	$ 90,980	$64,387	$ 35	$ 155,435
Comprehensive income:						
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
Comprehensive income:						
Net income	–	–	–	37,151	–	37,151
Foreign currency translation adjustment	–	–	–	–	16	16
Total comprehensive income						37,167
Exercise of stock options and other	–	1	5,326	–	–	5,327
Tax benefit of option exercises	–	–	11,467	–	–	11,467
Share-based employee compensation expense	–	–	13,982	–	–	13,982
Balance, August 31, 2006	$ –	$ 35	$140,200	$134,622	$ 16	$ 274,873
Comprehensive income:						
Net income	–	–	–	45,121	–	45,121
Net change in fair value of interest rate swap, net of income tax benefit of $133	–	–	–	–	(205)	(205)
Foreign currency translation adjustment	–	–	–	–	137	137
Total comprehensive income						45,053
Sale of unregistered common stock	–	–	5,000	–	–	5,000
Repurchases of common stock	–	–	(552)	(5,102)	–	(5,654)
Exercise of stock options and other	–	–	11,221	–	–	11,221
Tax benefit of option exercises	–	–	13,421	–	–	13,421
Share-based employee compensation expense	–	–	18,836	–	–	18,836
Balance, August 31, 2007	**$ –**	**$ 35**	**$188,126**	**$174,641**	**$ (52)**	**$ 362,750**

See accompanying notes to the consolidated financial statements.

Consolidated Statements of Cash Flows

Year ended August 31, (In thousands)	2007	2006	2005
Cash flows from operating activities:			
Net income	**$ 45,121**	$ 37,151	$ 33,084
Adjustments to reconcile net income to net cash provided by operating activities, net of business acquisitions:			
Depreciation and amortization	**37,044**	24,517	22,408
Amortization of deferred loan costs	**991**	476	488
Share-based employee compensation expense	**18,836**	13,982	494
Excess tax benefits from share-based payment arrangements	**(12,152)**	(10,936)	11,672
Increase in accounts receivable, net	**(2,749)**	(12,281)	(6,485)
(Increase) decrease in other current assets	**(3,299)**	(3,716)	1,098
(Decrease) increase in accounts payable	**(1,143)**	5,599	(3,562)
(Decrease) increase in accrued salaries and benefits	**(21,362)**	9,162	18,880
Increase in other current liabilities	**52,227**	46,434	820
Deferred income taxes	**(10,866)**	(11,217)	(5,456)
Other	**5,092**	3,621	2,003
Decrease (increase) in other assets	**834**	(1,539)	633
Payments on other long-term liabilities	**(1,247)**	(1,445)	(872)
Net cash flows provided by operating activities	**107,327**	99,808	75,205
Cash flows from investing activities:			
Acquisition of property and equipment	**(29,507)**	(27,356)	(16,161)
Purchase of investment	**(9,045)**	–	(2,000)
Proceeds on sale of investments	**–**	–	9,040
Acquisitions, net of cash acquired	**(493,071)**	(115)	(1,120)
Other, net	**(13)**	–	–
Net cash flows used in investing activities	**(531,636)**	(27,471)	(10,241)
Cash flows from financing activities:			
Decrease (increase) in restricted cash	**–**	3,811	(2,287)
Proceeds from issuance of long-term debt	**350,000**	–	48,000
Deferred loan costs	**(4,357)**	(924)	(730)
Proceeds from sale of unregistered common stock	**5,000**	–	–
Repurchases of common stock	**(5,654)**	–	–
Excess tax benefits from share-based payment arrangements	**12,152**	10,936	–
Exercise of stock options	**11,221**	5,328	4,599
Payments of long-term debt	**(51,190)**	(163)	(96,226)
Net cash flows provided by (used in) financing activities	**317,172**	18,988	(46,644)
Net (decrease) increase in cash and cash equivalents	**(107,137)**	91,325	18,320
Cash and cash equivalents, beginning of period	**154,792**	63,467	45,147
Cash and cash equivalents, end of period	**$ 47,655**	$ 154,792	$ 63,467
Supplemental disclosure of cash flow information:			
Cash paid during the year for interest	**$ 14,042**	$ 548	$ 1,099
Cash paid during the year for income taxes	**$ 38,580**	$ 16,415	$ 18,198
Noncash Activities:			
Issuance of unregistered common stock associated with Health IQ acquisition	**$ –**	$ –	$ 1,544

See accompanying notes to the consolidated financial statements.

Notes to Consolidated Financial Statements
Years Ended August 31, 2007, 2006 and 2005

1. Summary of Significant Accounting Policies

Healthways, Inc. and its wholly-owned subsidiaries provide specialized, comprehensive Health and Care Support solutions to help people maintain or improve their health and, as a result, reduce overall healthcare costs.

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, net - Billed receivables primarily represent fees that are contractually due in the ordinary course of providing our services, net of contractual adjustments and allowances for doubtful accounts. Unbilled receivables primarily represent fees for service based on the estimated utilization of fitness facilities and are generally billed in the following month. Historically, we have experienced minimal instances of customer non-payment and therefore consider our accounts receivable to be collectible, but we may provide reserves, when appropriate, for doubtful accounts and for billing adjustments 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 one to twelve years. Depreciation expense for the years ended August 31, 2007, 2006, and 2005 was $25.6 million, $20.6 million, and $18.5 million, respectively, including amortization of assets recorded under capital leases.

f. Other Assets - Other assets consist primarily of long-term investments and deferred loan costs net of accumulated amortization. We account for these long-term investments in accordance with Statement of Financial Accounting Standards ("SFAS") No. 115, "Accounting for Certain Investments in Debt and Equity Securities" and have classified them as available-for-sale. Available-for-sale securities are carried at fair value, with unrealized gains and losses reported in other comprehensive income.

g. Intangible Assets - Intangible assets subject to amortization primarily include acquired technology, customer contracts, patents, distributor and provider networks, and other intangible assets which we amortize on a straight-line basis over estimated useful lives ranging from one to 14 years. We assess the potential impairment of intangible assets subject to amortization whenever events or changes in circumstances indicate that the carrying values may not be recoverable.

Intangible assets not subject to amortization at August 31, 2007 and 2006 consist of trade names of $33.4 million and $4.3 million, respectively. We review intangible assets not subject to amortization on an annual basis or more frequently whenever events or circumstances indicate that the assets might be impaired. See Note 5 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. Accumulated amortization of goodwill at August 31, 2007 and 2006 was $5.1 million.

In accordance with 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, 2007 as required by SFAS No. 142 and concluded that no impairment of goodwill exists.

Notes to Consolidated Financial Statements
Years Ended August 31, 2007, 2006 and 2005

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 typically set the PMPM rates during contract negotiations with customers based on the value we expect our programs to create and a sharing of that value between the customer and the Company. In some contracts, the PMPM rates may differ between a customer's lines of business (e.g., PPO, HMO, Medicare Advantage). In addition, some of our services are billed on a fee for service basis.

Some of our contracts provide that a portion (up to 100%) of our fees may be refundable to the customer ("performance-based") if our programs do not achieve, when compared to a baseline year, a targeted percentage reduction in the customer's healthcare costs and selected clinical and/or other criteria that focus on improving the health of the members. Approximately 4% of revenues recorded during fiscal 2007 were performance-based and were subject to final reconciliation as of August 31, 2007. 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 generally bill our customers each month for the entire amount of the fees contractually due for the prior month's enrollment, which typically includes the amount, if any, that is performance-based and may be subject to refund should we not meet performance targets. Deferred revenues can arise from contracts which permit upfront billing and collection of fees covering the entire contractual service period, generally 12 months. Contractually, we cannot bill for any incentive bonus until after contract settlement. Fees for service are typically billed in the month after the services are provided.

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

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

Substantially all of the fees under the Medicare Health Support ("MHS") pilots 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 the Centers for Medicare & Medicaid Services ("CMS")) of 5.0%. 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 5.0% at the end of the pilots. Under the amendment to our agreement for 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. 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 summary 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."

Notes to Consolidated Financial Statements
Years Ended August 31, 2007, 2006 and 2005

Only in the event we do not meet performance levels by the end of the measurement period, typically one year, are we contractually obligated to refund some or all of the performance-based fees. We would only reverse revenues that we had already recognized if performance to date in the measurement period, previously above targeted levels, subsequently dropped below targeted levels. Historically, any such adjustments have been immaterial to our financial condition and results of operations.

During the settlement process under a contract, which generally occurs six to eight months after the end of a contract year, we settle any performance-based fees and reconcile healthcare claims and clinical data. As of August 31, 2007, performance-based fees that have not yet been settled with our customers but that have been recognized as revenue in the current and prior years totaled approximately $43.0 million. Of this amount, $8.5 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 $34.5 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 2007, we recognized a net decrease in revenue of $2.2 million that related to services provided prior to fiscal 2007.

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 12 for further information on share-based compensation.

n. Derivative Instruments and Hedging Activities – In accordance with SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended, we recognize derivative instruments at their fair values as either assets or liabilities in the consolidated balance sheet. Changes in the fair value of derivatives are recognized in other comprehensive income (for the effective portion of the gain or loss) or earnings (for the ineffective portion of the gain or loss). The effective portion, which is initially recorded to other comprehensive income, is reclassified into earnings when the forecasted transaction affects earnings. We entered into an interest rate swap agreement on December 21, 2006 which is subject to SFAS No. 133. See Note 7 for further information.

o. 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

Notes to Consolidated Financial Statements
Years Ended August 31, 2007, 2006 and 2005

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. The adoption of FIN No. 48 on September 1, 2007 is not expected to have a material effect 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.

Fair Value Option for Financial Assets and Financial Liabilities

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115." SFAS No. 159 provides entities with the one-time option to measure financial instruments and certain other items at fair value, with changes in fair value recognized in earnings as they occur. The fair value option may be applied instrument by instrument (with a few exceptions), is irrevocable, and must be applied to entire instruments and not to portions of an instrument. SFAS No. 159 is effective for financial statements issued for fiscal years beginning after November 15, 2007. We have not yet completed our analysis of the impact that the implementation of SFAS No. 159 will have on our results of operations or financial condition.

3. Business Acquisitions

On December 1, 2006, we acquired Axia Health Management, Inc. ("Axia"), a national provider of preventive health and wellness programs. The addition of Axia furthers our continuing strategy to provide a full spectrum of integrated, personalized, and evidence-based interventions to maintain or improve health and productivity.

We paid an aggregate of $467.0 million for Axia, including transaction-related costs of $5.2 million, which was funded through the use of approximately $117.0 million in available cash and $350.0 million in borrowings under a $600.0 million credit facility, as discussed in Note 8 below. At the closing, we deposited $35.0 million of the purchase price to be held in escrow until approximately December 31, 2007 to satisfy any potential indemnification claims. We also deposited an additional $9.0 million of the purchase price, which was held in escrow to satisfy a portion of certain pre-existing potential earnout obligations (the "Earnout Obligations"). As of August 31, 2007, the Earnout Obligations were completely satisfied.

At the close of the acquisition, L. Ben Lytle, who served as the chief executive officer of Axia prior to the acquisition, purchased 123,305 shares of Healthways common stock for $5.0 million under the terms of a Subscription Agreement dated October 11, 2006.

The total purchase price was allocated to Axia's net tangible and identifiable intangible assets based on their estimated fair values. The estimated fair values of certain assets and liabilities were determined with the assistance of independent third-party valuation firms. The total purchase price was allocated as follows (excluding debt and cash acquired) and is subject to adjustments, primarily related to certain working capital adjustments:

(In $000s)	
Current assets	$ 28,512
Property and equipment	4,596
Other assets	(34)
Identifiable intangible assets	95,826
Goodwill	384,753
Current liabilities	(20,556)
Long-term liabilities	(26,102)
Total preliminary purchase price	$466,995

Notes to Consolidated Financial Statements
Years Ended August 31, 2007, 2006 and 2005

The identifiable intangible assets acquired consist of the following:

(In $000s)	Fair Value	Weighted Average Useful Life (Years)
Intangible assets subject to amortization:		
Acquired technology	$ 12,469	5
Customer contracts	44,013	8
Distributor and provider networks	8,709	8
Other	1,586	7
	66,777	7
Intangible assets not subject to amortization:		
Trade name	29,049	n/a
Total identifiable intangible assets acquired	$ 95,826	

The results of operations of Axia were consolidated with those of the Company beginning on December 1, 2006. The unaudited pro forma combined results of operations as if the transaction had occurred on September 1, 2005 are as follows:

Year Ended August 31, (In $000s, except per share amounts)	2007	2006
Revenues	**$ 654,503**	$ 532,254
Net income	**42,970**	30,000
Earnings per share:		
Basic	**1.23**	0.87
Diluted	**1.16**	0.82

The unaudited pro forma combined results of operations shown above include certain pro forma adjustments described in our Current Report on Form 8-K/A filed with the Securities and Exchange Commission on February 7, 2007.

4. Goodwill

The change in carrying amount of goodwill during the years ended August 31, 2007 and 2006 is shown below:

(In $000s)	
Balance, August 31, 2005	$ 96,020
Health IQ purchase price adjustment	115
Balance, August 31, 2006	96,135
Purchase of Axia	384,753
Health IQ purchase price adjustment	792
Other business acquisitions	1,904
Balance, August 31, 2007	$ 483,584

The Health IQ purchase price adjustments relate 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. The goodwill from the purchase of Axia is not expected to be deductible for tax purposes.

Notes to Consolidated Financial Statements
Years Ended August 31, 2007, 2006 and 2005

5. Intangible Assets

Intangible assets subject to amortization at August 31, 2007 consist of the following:

(In $000s)	Gross Carrying Amount	Accumulated Amortization	Net
Acquired technology	$ 22,631	$ 10,252	$ 12,379
Customer contracts	53,150	11,373	41,777
Patents	22,595	183	22,412
Distributor and provider networks	8,709	916	7,793
Other	2,137	392	1,745
Total	$ 109,222	$ 23,116	$ 86,106

Intangible assets subject to amortization at August 31, 2006 consisted 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 are being amortized over estimated useful lives ranging from one to 14 years. Total amortization expense for the years ended August 31, 2007 and 2006 was $11.5 million and $3.9 million, respectively. Estimated amortization expense is $16.0 million for fiscal 2008, $12.1 million for fiscal 2009, $11.0 million for fiscal 2010, $10.6 million for fiscal 2011, $8.9 million for fiscal 2012, and $27.4 million thereafter.

Intangible assets not subject to amortization at August 31, 2007 and 2006 consist of trade names of $33.4 million and $4.3 million, respectively.

6. Income Taxes

Income tax expense is comprised of the following:

Year ended August 31,	2007	2006	2005
(In $000s)			
Current taxes			
Federal	**$ 34,187**	$ 29,247	$ 22,750
State	**6,465**	5,977	4,416
Deferred taxes			
Federal	**(8,618)**	(9,312)	(4,941)
State	**(1,871)**	(1,903)	(514)
Total	**$ 30,163**	$ 24,009	$ 21,711

Notes to Consolidated Financial Statements
Years Ended August 31, 2007, 2006 and 2005

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, 2007 and 2006:

At August 31,	2007	2006
(In $000s)		
Deferred tax asset:		
Accruals and reserves	**$ 4,603**	$ 2,681
Spin-off stock option adjustment	**–**	13
Deferred compensation	**7,747**	5,111
Share-based payments	**12,118**	5,523
Net operating loss carryforwards	**9,001**	–
Other assets and liabilities	**133**	–
Capital loss carryforward	**–**	97
	33,602	13,425
Valuation allowance	**(841)**	(97)
	32,761	13,328
Deferred tax liability:		
Property and equipment	**3,199**	2,312
Intangible assets	**36,362**	4,733
Other assets and liabilities	**64**	–
	39,625	7,045
Net deferred tax asset (liability)	**$ (6,864)**	$ 6,283
Net current deferred tax asset	**$ 7,145**	$ 3,726
Net long-term deferred tax asset (liability)	**(14,009)**	2,557
	$ (6,864)	$ 6,283

The valuation allowance increased by $0.7 million from August 31, 2006 to August 31, 2007 due primarily to the establishment of a valuation allowance against deferred tax assets in non-U.S. jurisdictions with a recent history of losses. Based on the Company's historical and expected future taxable earnings, and a consideration of available tax planning strategies, management believes it is more likely than not that the Company will realize the benefit of the existing deferred tax assets, net of the valuation allowance, at August 31, 2007.

For fiscal 2007 and 2006, the tax benefit of stock option compensation, excluding the 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. For fiscal 2007 a tax benefit of $133,000 related to our interest rate swap agreement (see Note 7) has been recorded to stockholders' equity as a component of other comprehensive income (loss).

At August 31, 2007 we had foreign net operating loss carryforwards, before valuation allowances, of approximately $2.7 million with an indefinite carryforward period and approximately $23.3 million of federal loss carryforwards related to the acquisition of Axia. The federal loss carryforwards are subject to an annual limitation under Internal Revenue Code Section 382 and also have expiration dates ranging from 2011 until 2020.

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

Year ended August 31,	2007	2006	2005
(In $000s)			
Statutory federal income tax	**$ 26,349**	$ 21,406	$ 19,178
State income taxes, less federal income tax benefit	**3,133**	2,495	2,249
Other	**681**	108	284
Income tax expense	**$ 30,163**	$ 24,009	$ 21,711

Notes to Consolidated Financial Statements
Years Ended August 31, 2007, 2006 and 2005

7. Derivative Instruments and Hedging Activities

SFAS No. 133, "Accounting for Derivative Investments and Hedging Activities," as amended, establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. It requires companies to record all derivatives at estimated fair value as either assets or liabilities on the balance sheet and to recognize the unrealized gains and losses, the treatment of which depends on whether the derivative is designated as a hedging instrument.

As a result of our investment in international initiatives, we are exposed to foreign currency exchange rate risks. A significant portion of these risks is economically hedged with currency options and forward contracts in order to minimize our exposure to fluctuations in foreign currency exchange rates. Principal currencies hedged include the Euro and British pound. These derivative instruments serve as economic hedges and do not qualify for hedge accounting treatment under SFAS No. 133. Accordingly, they require current period mark-to-market accounting, with any change in fair value being recorded each period in the statement of operations. We record the fair market value of our derivatives, based on information provided by reliable third parties, as other current assets and accrued liabilities. We routinely monitor our foreign currency exposures to maximize the overall effectiveness of our foreign currency hedge positions.

On December 21, 2006, we entered into an amortizing fixed interest rate swap agreement to reduce our exposure to interest rate fluctuations on our floating rate debt commitments. Under this interest rate swap agreement, the interest rate is fixed with respect to specified amounts of notional principal. The swap is accounted for in accordance with SFAS No. 133 and was designated at its inception as a qualifying cash flow hedge; thus, it is recorded at estimated fair value in the balance sheet, with changes in fair value being reported in other comprehensive income. The fair value of the swap at August 31, 2007 of ($0.3) million has been reported in other long-term liabilities with an offset, net of tax, included in "accumulated other comprehensive loss" in the consolidated balance sheet.

8. Long-Term Debt

On December 1, 2006, we entered into a Third Amended and Restated Revolving Credit and Term Loan Agreement (the "Third Amended Credit Agreement"). The Third Amended Credit Agreement provides us with a $400.0 million revolving credit facility, including a swingline sub facility of $10.0 million and a $75.0 million sub facility for letters of credit, a $200.0 million term loan facility, and an uncommitted incremental accordion facility of $200.0 million. As of August 31, 2007, availability under our revolving credit facility totaled $298.9 million.

Revolving advances under the Third Amended Credit Agreement generally bear interest, at our option, at 1) LIBOR plus a spread of 0.875% to 1.750% or 2) the greater of the federal funds rate plus 0.5%, or the prime rate, plus a spread of 0.000% to 0.250%. In February 2007, we amended the Third Amended Credit Agreement such that term loan borrowings generally bear interest, at our option, at 1) LIBOR plus 1.50% or 2) the greater of the federal funds rate plus 0.5%, or the prime rate. The Third Amended Credit Agreement also provides for a fee ranging between 0.150% and 0.300% of unused commitments. The Third Amended Credit Agreement is secured by guarantees from most of the Company's domestic subsidiaries and by security interests in substantially all of the Company's and such subsidiaries' assets.

We are required to repay outstanding revolving loans on the revolving commitment termination date, which is December 1, 2011. We are required to repay term loans in quarterly principal installments aggregating $0.5 million each, which commenced on March 31, 2007, and the entire unpaid principal balance of the term loans is due and payable at maturity on December 1, 2013. The following table summarizes the minimum annual principal payments and repayments of the revolving advances under the Third Amended Credit Agreement for each of the next five fiscal years and thereafter:

(In $000s)

Year ending August 31,	
2008	$ 2,000
2009	2,000
2010	2,000
2011	2,000
2012	102,000
2013 and thereafter	189,000
Total	$ 299,000

Notes to Consolidated Financial Statements
Years Ended August 31, 2007, 2006 and 2005

The Third 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. On December 21, 2006, we entered into an amortizing fixed interest rate swap agreement for the management of interest rate exposure. By entering into this interest rate swap agreement, we effectively converted $230.0 million of floating rate debt to a fixed obligation with an interest rate of 4.995%. The principal value of the swap arrangement amortizes over a 39-month period and terminates on March 31, 2010. We currently believe that we meet the hedge accounting criteria under SFAS No. 133 in accounting for the interest rate swap agreement.

9. Fair Value of Financial Instruments

In accordance with SFAS No. 107, "Disclosures About Fair Value of Financial Instruments," we used the following methods to estimate the fair value of each class of financial instruments:

a. Cash and cash equivalents – The carrying amounts at August 31, 2007 and 2006 approximate fair value because of the short maturity of those instruments (less than three months).

b. Long-term investments – Long-term investments consist primarily of available-for-sale securities whose carrying amount at August 31, 2007 approximates fair value.

c. Foreign currency contracts – The fair value of foreign currency contracts is estimated by obtaining quotes from brokers. The carrying amount at August 31, 2007 approximates fair value.

d. Interest rate swap – The fair value of our interest rate swap agreement is the amount at which it could be settled, based on estimates obtained from the counterparty. The carrying amount at August 31, 2007 approximates fair value.

e. Long-term debt – The estimated fair value of outstanding borrowings under the Third Amended Credit Agreement is based on the average of the prices set by the issuing bank given current market conditions and is not necessarily indicative of the amount we could realize in a current market exchange. The fair value and carrying amounts of outstanding borrowings under the Third Amended Credit Agreement at August 31, 2007 are $293.3 million and $299.0 million, respectively. As of August 31, 2006, there was not a material difference between the carrying amount and the fair value of our debt.

10. 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, 2007 and 2006, other long-term liabilities included vested amounts under the plan of $7.6 million and $6.7 million, respectively, net of the current portions of $1.9 million and $1.4 million, respectively. For the next five fiscal years, we must make estimated plan payments of $1.9 million, $1.2 million, $0.7 million, $0.5 million, and $0.1 million, respectively.

11. Leases

We maintain operating lease agreements principally for our corporate office space, our call centers, and our operations support and training offices. Our corporate office leases cover approximately 180,000 square feet and expire from December 2007 to March 2011. We also lease office space for our 13 call center locations for an aggregate of approximately 331,000 square feet of space with lease terms expiring on various dates from 2009 to 2013. Our operations support and training offices contain approximately 94,000 square feet in aggregate and have lease terms expiring from 2008 to 2015.

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

Notes to Consolidated Financial Statements
Years Ended August 31, 2007, 2006 and 2005

by 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 $4.2 million to $6.3 million per year over the term of the lease. The Landlord will provide a tenant improvement allowance equal to $39.20 per square foot. We record leasehold improvement incentives as deferred rent and amortize them as reductions to rent expense over the lease term. We recognize rent expense on a straight-line basis over the lease term.

Most of our operating leases include escalation clauses, some of which are fixed amounts, and some of which reflect changes in price indices. Certain operating leases contain renewal options to extend the lease for additional periods. For the years ended August 31, 2007, 2006 and 2005, rent expense under lease agreements was approximately $10.6 million, $7.7 million, and $6.0 million, respectively. Our capital lease obligations are included in long-term debt and the current portion of long-term debt.

The following table summarizes our future minimum lease payments, net of 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
2008	$ 229	$ 12,766
2009	60	12,277
2010	–	12,068
2011	–	11,019
2012	–	9,681
2013 and thereafter	–	66,693
Total minimum lease payments	289	$ 124,504
Less amount representing interest	(17)	
Present value of net minimum lease payments	272	
Less current portion	(213)	
	$ 59	

12. 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." Effective September 1, 2005, we adopted SFAS No. 123(R) using the modified prospective transition method. In accordance with the modified prospective method, we have not restated prior period results.

For the year ended August 31, 2005, we recorded compensation expense under APB No. 25 of approximately $0.5 million. 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 for the year ended August 31, 2005. We generally recognize compensation expense related to fixed award stock options with graded vesting on a straight-line basis over the vesting period.

For the years ended August 31, 2007 and 2006, we recognized share-based compensation costs of $18.8 million and $14.0 million, respectively, which consisted of $8.4 million and $6.6 million in cost of services, respectively, and $10.4 million and $7.4 million in selling, general and administrative expenses, respectively. We also recognized a total income tax benefit in the statement of operations for share-based compensation arrangements of $7.4 million and $5.5 million for the years ended August 31, 2007 and 2006, respectively. We did not capitalize any share-based compensation costs during fiscal 2007, 2006, or 2005.

Notes to Consolidated Financial Statements
Years Ended August 31, 2007, 2006 and 2005

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 year ended August 31, 2005:

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

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 based on service conditions. 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, 2007, we have reserved approximately 1.9 million shares for future equity grants under our stock incentive plans.

As of August 31, 2007, there was $32.3 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 2.5 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 years ended August 31, 2007 and 2006, we 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 2007 and 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 year ended August 31, 2005, 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.

Notes to Consolidated Financial Statements
Years Ended August 31, 2007, 2006 and 2005

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, 2007, 2006, and 2005:

Year ended August 31,	2007	2006	2005
Weighted average grant-date fair value of options	**$ 22.08**	$ 22.61	$ 20.02
Assumptions:			
Expected volatility	**48.7%**	47.7%	49.8%
Expected dividends	**–**	–	–
Expected term (in years)	**5.5**	5.3	5.7
Risk-free rate	**5.1%**	3.8%	3.8%

A summary of option activity as of August 31, 2007 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, 2006	5,836	$ 18.87		
Granted	479	43.67		
Exercised	(1,009)	11.06		
Forfeited or expired	(61)	33.90		
Outstanding at August 31, 2007	5,245	22.46	5.5	$ 143,716
Exercisable at August 31, 2007	2,985	12.14	5.0	$ 112,428

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 2007, 2006 and 2005 was $35.9 million, $29.0 million, and $29.8 million, respectively.

Cash received from option exercises under all share-based payment arrangements during fiscal 2007 was $11.2 million. The actual tax benefit realized during fiscal 2007 for the tax deductions from option exercises totaled $14.2 million. We issue new shares of common stock upon exercise of stock options.

Restricted Stock and Restricted Stock Units

The fair value of restricted stock and restricted stock units ("nonvested shares") is determined based on the closing bid price of the Company's common stock on the grant date. The weighted average grant-date fair value of nonvested shares granted during the years ended August 31, 2007, 2006 and 2005 was $43.76, $47.40 and $42.51, respectively.

The following table shows a summary of our nonvested shares as of August 31, 2007 as well as activity during the year then ended. The total fair value of shares vested during fiscal 2007, 2006, and 2005 was $0.5 million, $0.4 million, and $16,000, respectively.

Nonvested Shares	Shares (000s)	Weighted Average Grant-Date Fair Value
Nonvested at September 1, 2006	160	$ 43.82
Granted	229	43.62
Vested	(12)	40.10
Forfeited	(13)	44.79
Nonvested at August 31, 2007	364	43.76

Notes to Consolidated Financial Statements
Years Ended August 31, 2007, 2006 and 2005

13. Comprehensive Income

Comprehensive income, net of income taxes, was $45.1 million, $37.2 million, and $33.0 million for the years ended August 31, 2007, 2006, and 2005, respectively.

14. Earnings Per Share

The following is a reconciliation of the numerator and denominator of basic and diluted earnings per share:

Year ended August 31, (In 000s, except per share data)	2007	2006	2005
Numerator:			
Net income - numerator for basic earnings per share	**$ 45,121**	$ 37,151	$ 33,084
Effect of dilutive securities	**–**	–	–
Numerator for diluted earnings per share	**$ 45,121**	$ 37,151	$ 33,084
Denominator:			
Shares used for basic earnings per share	**35,049**	34,348	33,241
Effect of dilutive securities outstanding:			
Non-qualified stock options	**1,887**	2,015	2,449
Restricted stock units	**66**	16	1
Shares used for diluted earnings per share	**37,002**	36,379	35,691
Earnings per share:			
Basic	**$ 1.29**	$ 1.08	$ 1.00
Diluted	**$ 1.22**	$ 1.02	$ 0.93
Dilutive securities outstanding not included in the computation of earnings per share because their effect is antidilutive:	**1,117**	749	610

15. Stockholder Rights Plan

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

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

16. Employee Benefits

We have a 401(k) Retirement Savings Plan (the "Plan") available to substantially all of our employees. Employees can contribute up to a certain percentage of their base compensation as defined in the Plan. The Company matching contributions are subject to vesting requirements. Company contributions under the Plan totaled $3.8 million, $2.5 million, and $2.3 million for the years ended August 31, 2007, 2006, and 2005, respectively.

17. 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.

Notes to Consolidated Financial Statements
Years Ended August 31, 2007, 2006 and 2005

In connection with the acquisition of Axia, we assumed certain potential Earnout Obligations up to an aggregate amount of $18.0 million. We deposited $9.0 million of the purchase price in escrow to satisfy a portion of these Earnout Obligations. Under the terms of the stock purchase agreement, we are responsible for payment of one-half of the total Earnout Obligations, with the other one-half being paid through the $9.0 million held in escrow. As of August 31, 2007, the Earnout Obligations were completely satisfied.

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. The plaintiff recently agreed to dismiss its claims against the medical directors with prejudice, and on February 7, 2007 the court granted the plaintiff's motion and dismissed all claims against all named medical directors.

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 a related matter, 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 WPMC, initial arbitration proceedings were commenced during the third quarter of fiscal 2006. During September 2007, the parties to this matter agreed to place the arbitration on hold for an indefinite period.

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 the 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.

18. 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. We have aggregated several operating segments into one reportable segment, Health and Care Support. 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 22% of our fiscal 2007 revenues from one customer. No other customer comprised more than 10% of our revenues for the year. In fiscal 2006 and 2005, two customers each comprised more than 10% of revenues for the year, comprising in the aggregate approximately 38% of our fiscal 2006 and fiscal 2005 revenues. Revenues from each of these customers individually totaled approximately 27% and 11%, respectively, of fiscal 2006 revenues, and 26% and 12%, respectively, of fiscal 2005 revenues.

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 as of August 31, 2007 and 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, 2007. 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, 2007 and 2006, and the consolidated results of their operations and their cash flows for each of the three years in the period ended August 31, 2007, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Healthways, Inc. and Subsidiaries' internal control over financial reporting as of August 31, 2007, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated October 25, 2007 expressed an unqualified opinion thereon.

Ernst + Young LLP

Nashville, Tennessee
October 25, 2007

Quarterly Financial Information (unaudited)

Fiscal 2007 (In thousands, except per share data)	First	Second	Third	Fourth
Revenues	**$ 117,055**	**$ 160,281**	**$ 167,900**	**$ 170,350**
Gross margin	**$ 33,871**	**$ 43,803** (1)	**$ 44,873** (1)	**$ 47,638**
Income before income taxes	**$ 19,809**	**$ 18,266**	**$ 17,145**	**$ 20,063**
Net income	**$ 11,834**	**$ 11,024**	**$ 10,792**	**$ 11,471**
Basic earnings per share (2)	**$ 0.34**	**$ 0.32**	**$ 0.31**	**$ 0.32**
Diluted earnings per share (2)	**$ 0.32**	**$ 0.30**	**$ 0.29**	**$ 0.31**

Fiscal 2006 (In thousands, except per share data)	First	Second	Third	Fourth
Revenues	$ 90,592	$ 100,021	$ 106,820	$ 114,876
Gross margin (3)	$ 22,317	$ 24,347	$ 27,917	$ 36,618
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 (2)	$ 0.19	$ 0.21	$ 0.27	$ 0.41
Diluted earnings per share (2)	$ 0.18	$ 0.20	$ 0.26	$ 0.38

(1) Reflects certain reclassifications from selling, general and administrative expenses to cost of services that were made to conform to current classifications.

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

(3) Reclassified to reflect depreciation and amortization attributable to cost of services.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.

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

Reconciliation of EBITDA to Net Income

Year Ended August 31, (In thousands)	2003	2004	2005	2006	2007
EBITDA (1)	$ 42,830	$ 65,262	$ 78,833	$ 86,730	$ 130,513
Interest expense	569	3,509	1,630	1,053	18,185
Income tax expense	12,837	17,245	21,711	24,009	30,163
Depreciation and amortization	10,950	18,450	22,408	24,517	37,044
Net income	$ 18,474	$ 26,058	$ 33,084	$ 37,151	$ 45,121

(1) Earnings before interest, taxes, depreciation and amortization ("EBITDA") is a non-GAAP financial measure. The Company excludes interest, taxes, depreciation and amortization from this measure and provides EBITDA to enhance investors' understanding of the Company's operating performance and its capacity to fund capital expenditures and working capital requirements. 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 EBITDA in isolation or as a substitute for net income determined in accordance with accounting principles generally accepted in the United States.

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, 2007 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, 2007.

Ernst & Young LLP, the independent registered public accounting firm that audited the Company's consolidated financial statements for the year ended August 31, 2007, has issued an attestation report on 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.

On December 1, 2006, we acquired Axia Health Management Inc, which constituted approximately $136.1 million of total assets as of August 31, 2007 and approximately $136.5 million of revenues for the year then ended. We have excluded Axia from our assessment of and conclusion on the effectiveness of our internal control over financial reporting. Excluding the Axia acquisition, there have been no changes in our internal controls over financial reporting during the quarter ended August 31, 2007 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 Healthways, Inc. and Subsidiaries' internal control over financial reporting as of August 31, 2007, 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 included in the accompanying Management's Annual Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the company's internal control over financial reporting based on our audit.

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

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

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

As indicated in the accompanying Management's Annual Report on Internal Control over Financial Reporting, management's assessment of and conclusion on the effectiveness of internal control over financial reporting did not include the internal controls of Axia Health Management, Inc., which is included in the August 31, 2007 consolidated financial statements of Healthways, Inc. and Subsidiaries and constituted approximately $136.1 million of total assets as of August 31, 2007 and approximately $136.5 million of revenues for the year then ended. Our audit of internal control over financial reporting of Healthways, Inc. and Subsidiaries also did not include an evaluation of the internal control over financial reporting of Axia Health Management, Inc.

In our opinion, Healthways, Inc. and Subsidiaries maintained, in all material respects, effective internal control over financial reporting as of August, 31, 2007, based on the COSO criteria.

We have also 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, 2007 and 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, 2007 of Healthways, Inc. and Subsidiaries and our report dated October 25, 2007 expressed an unqualified opinion thereon.

Ernst + Young LLP

Nashville, Tennessee
October 25, 2007

Directors and Executive Officers

Board of Directors

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First Chicago NBD Corporation

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Former Director of Health Services
Delta Air Lines

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Chairman and former Chief Executive Officer
Healthways, Inc.

Mary Jane England, M.D.
President of Regis College

Henry D. Herr
Former Executive Vice President and Chief Financial Officer
Healthways, Inc.

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

L. Ben Lytle
Former Chairman and Chief Executive Officer
Axia Health Management, LLC

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Director of the Center for Corporate Governance
University of Tennessee

William C. O'Neil, Jr.
Former Chairman, President and Chief Executive Officer
ClinTrials Research, Inc.

Alison Taunton - Rigby, Ph.D.
Chief Executive Officer
RiboNovix, Inc.

John A. Wickens
Former National Health Plan President
UnitedHealth Group

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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

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Nashville, Tennessee

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Nashville, Tennessee

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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
Nashville, Tennessee

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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

CORPORATE OFFICE
Healthways, Inc.
3841 Green Hills Village Drive
Nashville, Tennessee 37215
615/665-1122
www.healthways.com

REGISTRAR AND TRANSFER AGENT
National City Bank
Shareholder Services Group
P.O. 92301
LOC 01-5352
Cleveland, OH 44101-4301
Tel: (800) 622-7657
E-mail: shareholder.inquiries@nationalcity.com

FORM 10-K/INVESTOR CONTACT
A copy of the Healthways, Inc. Annual Report on Form 10-K for Fiscal 2007 (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 14, 2008, at 9:00 a.m. at the Loews Vanderbilt Hotel, 2100 West End Avenue, Nashville, Tennessee.

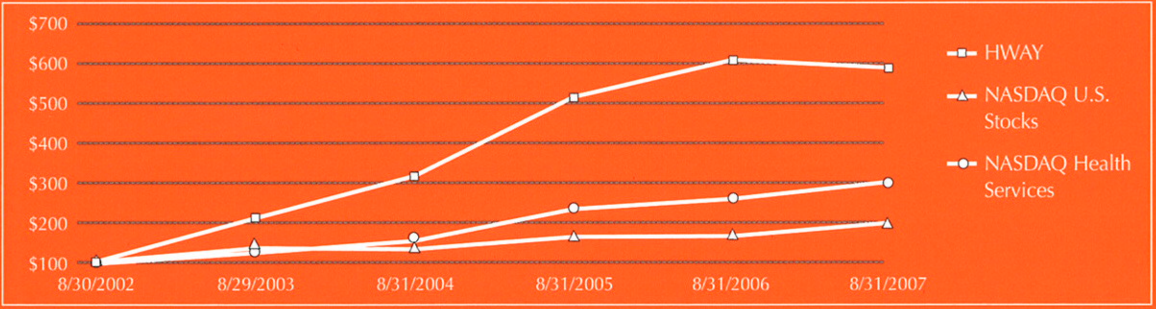
COMMON STOCK AND DIVIDEND INFORMATION
The common stock of Healthways, Inc. is traded in The Nasdaq Stock Market under the symbol HWAY. At October 22, 2007, there were approximately 38,650 holders of our Common Stock, including 173 stockholders of record. No cash dividends have been paid on the common 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, 2007	High	Low
First quarter	**$ 52.37**	**$ 37.55**
Second quarter	**49.58**	**42.64**
Third quarter	**48.76**	**41.58**
Fourth quarter	**56.90**	**42.77**

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

PERFORMANCE GRAPH
The following graph compares the total stockholder return of $100 invested on August 30, 2002 in (a) the Company, (b) the CRSP Index for NASDAQ Stock Market (U.S. Companies) ("NASDAQ U.S. Stocks") and (c) the CRSP Index for NASDAQ Health Services Stocks ("NASDAQ Health Services"), assuming the reinvestment of all dividends.



	8/30/2002	8/29/2003	8/31/2004	8/31/2005	8/31/2006	8/31/2007
HWAY	$100.0	$205.6	$316.5	$512.3	$605.2	$583.8
NASDAQ U.S. Stocks	100.0	137.8	140.3	164.7	168.1	198.5
NASDAQ Health Services	100.0	130.1	154.9	234.5	259.7	300.3

Notes:
A. The lines represent annual index levels derived from compounded daily returns that include all dividends.
B. The indexes are reweighted daily, using the market capitalization on the previous trading day.
C. If the monthly interval, based on the fiscal year end, is not a trading day, the preceding trading day is used.
D. The index level for all series was set to $100.00 on August 30, 2002.

The stock price performance shown on the graph above is not necessarily indicative of future price performance.


HEALTHWAYS
3841 Green Hills Village Drive
Nashville, Tennessee 37215
615/665-1122
www.healthways.com