

WEBMD CORP /NEW/  
Form 10-Q  
November 09, 2004

**Table of Contents**

---

---

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

---

**FORM 10-Q**

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2004  
or

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from \_\_\_\_\_ to \_\_\_\_\_  
Commission file number 0-24975

**WEBMD CORPORATION**

*(Exact name of registrant as specified in its charter)*

**Delaware**  
*(State or other jurisdiction of  
incorporation or organization)*

**94-3236644**  
*(I.R.S. Employer  
Identification Number)*

**669 River Drive, Center 2**

**Elmwood Park, New Jersey 07407-1361**  
*(Address of principal executive offices)*

**(201) 703-3400**

*(Registrant's telephone number, including area code)*

---

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

Yes  No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

As of November 4, 2004, there were 312,644,362 shares of the  
registrant's Common Stock outstanding.

WEBMD CORPORATION

QUARTERLY REPORT ON FORM 10-Q

For the period ended September 30, 2004

TABLE OF CONTENTS

	<u>Page Number</u>
<u>Cautionary Statement Regarding Forward-Looking Statements</u>	3
<u>Part I</u> <u>Financial Information</u>	
<u>Item 1.</u> <u>Financial Statements:</u>	
<u>Consolidated Balance Sheets as of September 30, 2004 (unaudited) and</u>	
<u>December 31, 2003</u>	4
<u>Unaudited Consolidated Statements of Operations for the three and nine</u>	
<u>months ended September 30, 2004 and 2003</u>	5
<u>Unaudited Consolidated Statements of Cash Flows for the nine months ended</u>	
<u>September 30, 2004 and 2003</u>	6
<u>Notes to Consolidated Financial Statements</u>	7
<u>Item 2.</u> <u>Management's Discussion and Analysis of Financial Condition and Results of</u>	
<u>Operations</u>	23
<u>Item 3.</u> <u>Quantitative and Qualitative Disclosures About Market Risk</u>	56
<u>Item 4.</u> <u>Controls and Procedures</u>	56
<u>Part II</u> <u>Other Information</u>	
<u>Item 1.</u> <u>Legal Proceedings</u>	57
<u>Item 2.</u> <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	59
<u>Item 4.</u> <u>Submission of Matters to a Vote of Security Holders</u>	59
<u>Item 6.</u> <u>Exhibits</u>	60
<u>Signatures</u>	61
<u>Exhibit Index</u>	E-1
<u>EX-3.1 11TH AMENDED AND RESTATED CERTIFICATE OF INCORPORATION</u>	
<u>EX-3.2 CERTIFICATE OF DESIGNATIONS</u>	
<u>EX-10.1 2004 NON-QUALIFIED STOCK OPTION PLAN / DAKOTA IMAGING, INC.</u>	
<u>EX-10.2 2004 NON-QUALIFIED STOCK OPTION PLAN / VIPS, INC.</u>	
<u>EX-31.1 SECTION 302 CERTIFICATION OF CEO</u>	
<u>EX-31.2 SECTION 302 CERTIFICATION OF CFO</u>	
<u>EX-32.1 SECTION 906 CERTIFICATION OF CEO</u>	
<u>EX-32.2 SECTION 906 CERTIFICATION OF CFO</u>	

WebMD®, dakota imaging™, Digital Office Manager®, DIM<sub>DX</sub>®, Envoy®, ExpressBill®, Intergy®, Medifax®, Medifax-EDI®, Medscape®, MEDPOR®, Medpulse®, POREX®, Publishers Circle®, The Little Blue Book™, The Little Yellow Book™, The Medical Manager®, ULTIA™, ViPS™, WebMD Health Hub™ and WellMed® are trademarks of WebMD Corporation or its subsidiaries.

**Table of Contents**

**CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS**

This Quarterly Report on Form 10-Q contains both historical and forward-looking statements. All statements other than statements of historical fact are, or may be deemed to be, forward-looking statements. These forward-looking statements are not based on historical facts, but rather reflect management's current expectations concerning future results and events. These forward-looking statements generally can be identified by use of expressions such as believe, expect, anticipate, intend, plan, foresee, likely, will or other similar words or phrases. Statements that describe our objectives, plans or goals are, or may be deemed to be, forward-looking statements. These forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, performance or achievements to be different from any future results, performance and achievements expressed or implied by these statements. In addition to the risk factors described in Management's Discussion and Analysis of Financial Condition and Results of Operations - Factors That May Affect Our Future Financial Condition or Results of Operations beginning on page 36, the following important risks and uncertainties could affect future results, causing those results to differ materially from those expressed in our forward-looking statements:

the failure to achieve sufficient levels of customer utilization and market acceptance of new or updated products and services,

the inability to successfully deploy new or updated applications,

difficulties in forming and maintaining relationships with customers and strategic partners,

the inability to attract and retain qualified personnel, and

general economic, business or regulatory conditions affecting the healthcare, information technology, Internet and plastic industries being less favorable than expected.

These factors and the risk factors described in Management's Discussion and Analysis of Financial Condition and Results of Operations - Factors That May Affect Our Future Financial Condition or Results of Operations beginning on page 36 are not necessarily all of the important factors that could cause actual results to differ materially from those expressed in any of our forward-looking statements. Other unknown or unpredictable factors also could have material adverse effects on our future results. The forward-looking statements included in this Quarterly Report on Form 10-Q are made only as of the date of this Quarterly Report. We expressly disclaim any intent or obligation to update any forward-looking statements to reflect subsequent events or circumstances.

**Table of Contents****PART I****FINANCIAL INFORMATION****ITEM 1. Financial Statements****WEBMD CORPORATION****CONSOLIDATED BALANCE SHEETS**  
(In thousands, except share and per share data)

	September 30, 2004	December 31, 2003
	(Unaudited)	
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 108,204	\$ 63,298
Short-term investments	25,784	207,383
Accounts receivable, net	203,288	181,173
Inventory	12,579	12,158
Current portion of prepaid content and distribution services	16,221	18,116
Other current assets	24,978	25,973
	<hr/>	<hr/>
Total current assets	391,054	508,101
Marketable debt securities	515,096	451,290
Marketable equity securities	3,373	4,744
Property and equipment, net	83,071	77,278
Prepaid content and distribution services	19,020	31,992
Goodwill	959,799	844,448
Intangible assets, net	270,426	184,130
Other assets	35,800	33,323
	<hr/>	<hr/>
	\$ 2,277,639	\$ 2,135,306
	<hr/>	<hr/>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 10,777	\$ 10,390
Accrued expenses	207,271	208,430
Deferred revenue	104,794	86,708
	<hr/>	<hr/>
Total current liabilities	322,842	305,528
3 1/4% convertible subordinated notes due 2007	299,999	299,999
1.75% convertible subordinated notes due 2023	350,000	350,000
Other long-term liabilities	974	1,182
Commitments and contingencies		
Convertible redeemable exchangeable preferred stock, \$0.0001 par value; 10,000 shares authorized, issued and outstanding at September 30, 2004	98,240	

Edgar Filing: WEBMD CORP /NEW/ - Form 10-Q

Stockholders equity:		
Preferred stock, \$0.0001 par value; 4,990,000 shares authorized; no shares issued		
Common stock, \$0.0001 par value; 900,000,000 shares authorized; 391,879,504 shares issued at September 30, 2004; 384,751,705 shares issued at December 31, 2003		
	39	38
Additional paid-in capital	11,767,066	11,726,734
Deferred stock compensation	(7,232)	(4,683)
Treasury stock, at cost; 79,394,471 shares at September 30, 2004; 76,576,865 shares at December 31, 2003		
	(370,125)	(347,858)
Accumulated deficit	(10,192,534)	(10,212,054)
Accumulated other comprehensive income	8,370	16,420
	<u>          </u>	<u>          </u>
Total stockholders equity	1,205,584	1,178,597
	<u>          </u>	<u>          </u>
	\$ 2,277,639	\$ 2,135,306
	<u>          </u>	<u>          </u>

See accompanying notes.

**Table of Contents****WEBMD CORPORATION****CONSOLIDATED STATEMENTS OF OPERATIONS**  
(In thousands, except per share data, unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Revenue	\$ 299,615	\$ 250,635	\$ 852,710	\$ 705,584
Costs and expenses:				
Cost of operations	168,571	149,270	495,174	410,556
Development and engineering	14,392	11,334	38,479	32,654
Sales, marketing, general and administrative	84,762	72,450	245,054	209,917
Depreciation, amortization and other	15,189	11,097	40,922	52,961
Legal expense	2,325	493	6,577	493
Restructuring and integration charge	4,535		4,535	
Interest income	4,512	6,401	14,506	16,434
Interest expense	4,843	4,703	14,429	10,444
Other income, net	94	3,039	578	4,340
Income from continuing operations before income tax provision	9,604	10,728	22,624	9,333
Income tax provision	1,435	1,273	2,979	3,261
Income from continuing operations	8,169	9,455	19,645	6,072
Loss from discontinued operations, net of income taxes		3,366		33,611
Net income (loss)	\$ 8,169	\$ 6,089	\$ 19,645	\$ (27,539)
Basic income (loss) per common share:				
Income from continuing operations	\$ 0.03	\$ 0.03	\$ 0.06	\$ 0.02
Loss from discontinued operations		(0.01)		(0.11)
Net income (loss)	\$ 0.03	\$ 0.02	\$ 0.06	\$ (0.09)
Diluted income (loss) per common share:				
Income from continuing operations	\$ 0.02	\$ 0.03	\$ 0.06	\$ 0.02
Loss from discontinued operations		(0.01)		(0.10)
Net income (loss)	\$ 0.02	\$ 0.02	\$ 0.06	\$ (0.08)
Weighted-average shares outstanding used in computing income (loss) per common share:				
Basic	312,366	305,471	311,379	304,121
Diluted	333,978	328,463	333,048	326,396

See accompanying notes.





Table of Contents

## WEBMD CORPORATION

**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(In thousands, unaudited)

	Nine Months Ended September 30,	
	2004	2003
<b>Cash flows from operating activities:</b>		
Net income (loss)	\$ 19,645	\$ (27,539)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Loss from discontinued operations		33,611
Depreciation, amortization and other	40,922	52,961
Amortization of debt issuance costs	2,255	1,505
Non-cash content and distribution services	14,893	18,224
Non-cash stock-based compensation	7,241	10,948
Gain on investments	(457)	(3,222)
Gain on sale of property and equipment	(121)	
Changes in operating assets and liabilities:		
Accounts receivable	(8,001)	3,580
Inventory	(417)	(1,144)
Prepaid content and distribution services	(26)	(537)
Accounts payable	(874)	(775)
Accrued expenses	(8,189)	(12,174)
Deferred revenue	9,284	(2,228)
Other, net	3,045	5,685
Net cash provided by continuing operations	79,200	78,895
Net cash provided by discontinued operations		5,130
Net cash provided by operating activities	79,200	84,025
<b>Cash flows from investing activities:</b>		
Proceeds from maturities and sales of available-for-sale securities	384,238	11,322
Proceeds from maturities and redemptions of held-to-maturity securities		157,919
Purchases of available-for-sale securities	(274,600)	(7,754)
Purchases of held-to-maturity securities		(590,113)
Proceeds received from sale of property and equipment	417	
Purchases of property and equipment	(24,889)	(13,643)
Proceeds received from sale of discontinued operations		46,500
Cash paid in business combinations, net of cash acquired	(225,375)	(133,471)
Other changes in equity of discontinued operations		1,754
Net cash used in continuing operations	(140,209)	(527,486)
Net cash used in discontinued operations		(2,529)
Net cash used in investing activities	(140,209)	(530,015)
<b>Cash flows from financing activities:</b>		
Proceeds from issuance of common stock	30,528	35,367
Payments of notes payable and other	(433)	(211)
Net proceeds from issuance of convertible debt		339,125
Net proceeds from issuance of preferred stock	98,115	
Purchases of treasury shares	(22,267)	(18,125)

Edgar Filing: WEBMD CORP /NEW/ - Form 10-Q

	_____	_____
Net cash provided by continuing operations	105,943	356,156
Net cash used in discontinued operations		(6,546)
	_____	_____
Net cash provided by financing activities	105,943	349,610
Effect of exchange rates on cash	(28)	711
	_____	_____
Net increase (decrease) in cash and cash equivalents	44,906	(95,669)
Changes in cash attributable to discontinued operations		3,945
Cash and cash equivalents at beginning of period	63,298	175,596
	_____	_____
Cash and cash equivalents at end of period	\$ 108,204	\$ 83,872
	_____	_____

See accompanying notes.

**Table of Contents****WEBMD CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(In thousands, except share and per share data, unaudited)****1. Summary of Significant Accounting Policies****Basis of Presentation**

The unaudited consolidated financial statements of WebMD Corporation (the Company) have been prepared by management and reflect all adjustments (consisting of only normal recurring adjustments) that, in the opinion of management, are necessary for a fair presentation of the interim periods presented. The results of operations for the three and nine months ended September 30, 2004 are not necessarily indicative of the results to be expected for any subsequent period or for the entire year ending December 31, 2004. Certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles have been condensed or omitted under the Securities and Exchange Commission's rules and regulations.

The unaudited consolidated financial statements and notes included herein should be read in conjunction with the Company's audited consolidated financial statements and notes for the year ended December 31, 2003, which were included in the Company's Annual Report on Form 10-K filed with the Securities and Exchange Commission.

**Accounting Estimates**

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. The Company is subject to uncertainties such as the impact of future events, economic, environmental and political factors and changes in the Company's business environment; therefore, actual results could differ from these estimates. Accordingly, the accounting estimates used in the preparation of the Company's financial statements will change as new events occur, as more experience is acquired, as additional information is obtained and as the Company's operating environment changes. Changes in estimates are made when circumstances warrant. Such changes in estimates and refinements in estimation methodologies are reflected in reported results of operations; if material, the effects of changes in estimates are disclosed in the notes to the consolidated financial statements. Significant estimates and assumptions by management affect: the allowance for doubtful accounts, the carrying value of inventory, the carrying value of prepaid content and distribution services, the carrying value of long-lived assets (including goodwill and intangible assets), the amortization period of long-lived assets (excluding goodwill), the carrying value, capitalization and amortization of software development costs, the carrying value of short-term and long-term investments, the provision for income taxes and related deferred tax accounts, certain accrued expenses, revenue recognition, contingencies, litigation and the value attributed to warrants issued for services.

**Inventory**

Inventory is stated at the lower of cost or market value using the first-in, first-out basis. Cost includes raw materials, direct labor and manufacturing overhead. Market value is based on current replacement cost for raw materials and supplies and on net realizable value for work-in-process and finished goods. Inventory consisted of the following as of September 30, 2004 and December 31, 2003:

	September 30, 2004	December 31, 2003
Raw materials and supplies	\$ 3,767	\$ 3,142
Work-in-process	1,423	1,394
Finished goods and other	7,389	7,622
	<u>          </u>	<u>          </u>
	\$ 12,579	\$ 12,158
	<u>          </u>	<u>          </u>



Table of Contents

## WEBMD CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**Accounting for Stock-Based Compensation**

The Company accounts for its stock-based employee compensation plans using the intrinsic value method under the recognition and measurement principles of APB Opinion No. 25, Accounting for Stock Issued to Employees ( APB No. 25 ), and related interpretations. No stock-based employee compensation cost is reflected in net income (loss) with respect to options granted with an exercise price equal to the market value of the underlying common stock on the date of grant. Stock-based awards to non-employees are accounted for based on provisions of SFAS No. 123, Accounting for Stock-Based Compensation ( SFAS No. 123 ), and EITF 96-18, Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services. The following table illustrates the effect on net income (loss) and net income (loss) per common share if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock-based employee compensation:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Net income (loss) as reported	\$ 8,169	\$ 6,089	\$ 19,645	\$ (27,539)
Add: Stock-based employee compensation expense included in reported net income (loss) (including stock-based employee compensation expense related to discontinued operations)	2,800	3,570	7,241	11,128
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards	(17,536)	(23,024)	(54,477)	(60,403)
Pro forma net loss	\$ (6,567)	\$ (13,365)	\$ (27,591)	\$ (76,814)
Net income (loss) per common share:				
Basic as reported	\$ 0.03	\$ 0.02	\$ 0.06	\$ (0.09)
Diluted as reported	\$ 0.02	\$ 0.02	\$ 0.06	\$ (0.08)
Basic and diluted pro forma	\$ (0.02)	\$ (0.04)	\$ (0.09)	\$ (0.25)

The pro forma results above are not intended to be indicative of or a projection of future results. Pro forma information regarding net income (loss) has been determined as if employee stock options granted subsequent to December 31, 1994 were accounted for under the fair value method of SFAS No. 123. The fair value for 2004 options was estimated at the date of grant using the Black-Scholes option pricing model employing weighted average assumptions that were substantially consistent with the 2003 assumptions except with respect to the volatility assumption, which was 0.6 for options granted during the nine months ended September 30, 2004. The 2003 assumptions were included in Note 15 to the consolidated financial statements contained in the Company's 2003 Annual Report on Form 10-K filed with the Securities and Exchange Commission.

The Company has elected to follow APB No. 25 and related interpretations in accounting for employee stock options because the alternative fair value accounting method provided for under SFAS No. 123 requires the use of option valuation models that were not developed for use in valuing employee stock options. The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions, including the expected stock price volatility. Because the Company's employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the



**Table of Contents****WEBMD CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

fair value estimates, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of the Company's employee stock options.

**Net Income (Loss) Per Common Share**

Basic income (loss) per common share and diluted income (loss) per common share are presented in conformity with SFAS No. 128, Earnings Per Share (SFAS No. 128). In accordance with SFAS No. 128, basic income (loss) per common share has been computed using the weighted-average number of shares of common stock outstanding during the period. Diluted income (loss) per common share has been computed using the weighted-average number of shares of common stock outstanding during the period, increased to consider the effect of potentially dilutive securities. The following table presents the calculation of basic and diluted income (loss) per common share (shares in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Basic and diluted income (loss):				
Income from continuing operations	\$ 8,169	\$ 9,455	\$ 19,645	\$ 6,072
Loss from discontinued operations		(3,366)		(33,611)
Net income (loss)	<u>\$ 8,169</u>	<u>\$ 6,089</u>	<u>\$ 19,645</u>	<u>\$ (27,539)</u>
Weighted-average shares Basic	312,366	305,471	311,379	304,121
Effect of dilutive securities:				
Employee stock options and warrants	10,974	22,992	14,070	22,275
Convertible redeemable exchangeable preferred stock	10,638		7,599	
Adjusted weighted-average shares after assumed conversions Diluted	<u>333,978</u>	<u>328,463</u>	<u>333,048</u>	<u>326,396</u>
Basic income (loss) per common share:				
Income from continuing operations	\$ 0.03	\$ 0.03	\$ 0.06	\$ 0.02
Loss from discontinued operations		(0.01)		(0.11)
Net income (loss)	<u>\$ 0.03</u>	<u>\$ 0.02</u>	<u>\$ 0.06</u>	<u>\$ (0.09)</u>
Diluted income (loss) per common share:				
Income from continuing operations	\$ 0.02	\$ 0.03	\$ 0.06	\$ 0.02
Loss from discontinued operations		(0.01)		(0.10)
Net income (loss)	<u>\$ 0.02</u>	<u>\$ 0.02</u>	<u>\$ 0.06</u>	<u>\$ (0.08)</u>

The Company has excluded convertible subordinated notes and restricted stock, as well as certain outstanding warrants and stock options, from the calculation of diluted income (loss) per common share because such securities were either anti-dilutive or were not convertible into common stock in accordance with their terms during the periods presented. The following table presents the total number of shares that could potentially dilute basic income (loss) per common share in the future that were not included in the





**Table of Contents****WEBMD CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

computation of diluted income (loss) per common share during the periods presented (shares in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Options, warrants and restricted stock	90,397	81,973	87,357	83,133
Convertible notes	55,129	55,129	55,129	55,129
	<u>145,526</u>	<u>137,102</u>	<u>142,486</u>	<u>138,262</u>

**Reclassifications**

Certain reclassifications have been made to the prior period financial statements to conform with the current period presentation.

**2. Business Combinations and Significant Transactions****2004 Acquisitions**

On August 11, 2004, the Company completed its acquisition of ViPS, Inc. ( ViPS ), a privately held provider of information technology, decision support solutions and consulting services to government, Blue Cross Blue Shield and commercial healthcare payers. ViPS develops and provides a broad range of solutions for claims processing, provider performance measurement, quality improvement, fraud detection, disease management and predictive modeling. The total purchase consideration for ViPS was approximately \$166,604 comprised of \$165,204 in cash, net of cash acquired, and \$1,400 of estimated acquisition costs, subject to customary post-closing adjustments. The acquisition was accounted for using the purchase method of accounting and, accordingly, the purchase price was allocated to the tangible and intangible assets acquired and the liabilities assumed on the basis of their respective fair values. In connection with the preliminary allocation of the purchase price, goodwill of \$66,342 and intangible assets subject to amortization of \$92,700 were recorded. The Company does not expect that the goodwill or intangible assets will be deductible for tax purposes. The intangible assets are comprised of \$56,300 relating to customer relationships with estimated useful lives ranging from ten to fifteen years, \$36,000 relating to acquired technology with estimated useful lives of five years and \$400 relating to a trade name with an estimated useful life of one year. The financial information of ViPS has been included in the financial statements of the Company from August 11, 2004, the closing date of the acquisition, and is included in the Transaction Services segment.

On July 16, 2004, the Company acquired Epor, Inc. ( Epor ), a privately held company based in Los Angeles, California. Epor manufactures porous plastic implant products for use in aesthetic and reconstructive surgery of the head and face. The total purchase consideration for Epor was approximately \$2,547. The financial information of Epor has been included in the financial statements of the Company from July 16, 2004, the closing date of the acquisition, and is included in the Plastic Technologies segment.

On April 30, 2004, the Company acquired Dakota Imaging, Inc. ( Dakota ), a privately held provider of automated healthcare claims processing technology and business process outsourcing services. Dakota's technology and services assist its customers in reducing costly manual processing of healthcare documents and increase auto-payment of medical claims through advanced data scrubbing. The Company paid approximately \$39,717 in cash at closing and has agreed to pay up to an additional \$25,000 in cash over a three-year period beginning in April 2005 if certain financial milestones are achieved. The acquisition was accounted for using the purchase method of accounting and, accordingly, the purchase

**Table of Contents**

**WEBMD CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

price was allocated to the tangible and intangible assets acquired and the liabilities assumed on the basis of their respective fair values. In connection with the preliminary allocation of the purchase price, goodwill of \$28,380 and intangible assets subject to amortization of \$13,100 were recorded. The Company does not expect that the goodwill or intangible assets will be deductible for tax purposes. The intangible assets are comprised of \$4,500 relating to customer relationships with estimated useful lives of ten years and \$8,600 relating to acquired technology with an estimated life of five years. The financial information of Dakota has been included in the financial statements of the Company from April 30, 2004, the closing date of the acquisition, and is included in the Transaction Services segment.

During the nine months ended September 30, 2004, the Company acquired one physician services company for an aggregate cost of \$70, which was paid in cash, and agreed to pay up to \$30 beginning in 2005 if the acquired company meets certain financial milestones. In connection with the preliminary allocation of the purchase price, intangible assets subject to amortization of \$85 were recorded, principally related to customer relationships and non-compete agreements. The financial information of this company has been included in the financial statements of the Company from the acquisition closing date and is included in the Physician Services segment.

**2003 Acquisitions**

On December 22, 2003, the Company completed its acquisition of Medifax-EDI, Inc. ( Medifax ), a privately held company based in Nashville, Tennessee. Medifax provides real-time medical eligibility transaction services and other claims management solutions to hospitals, medical centers, physician practices and other medical organizations throughout the United States. These services enable healthcare providers to verify insurance coverage for their patients on a real-time basis. The total purchase consideration was approximately \$277,519, comprised of \$276,065 in cash and \$1,454 of estimated acquisition costs, for all of the outstanding capital stock of Medifax. Prior to closing, Medifax distributed its Pharmacy Services companies to its owner and these companies were not included in the transaction. The acquisition was accounted for using the purchase method of accounting and, accordingly, the purchase price was allocated to the tangible and intangible assets acquired and the liabilities assumed on the basis of their respective fair values. In connection with the preliminary allocation of the purchase price, goodwill of \$179,090 and intangible assets subject to amortization of \$92,700 were recorded. The Company does not expect that the goodwill or intangible assets will be deductible for tax purposes. The intangible assets are comprised of \$72,600 relating to customer relationships with estimated useful lives of fifteen years, \$8,600 relating to acquired technology with an estimated useful life of five years, \$8,400 relating to payer connections with estimated useful lives of fifteen years and \$3,100 relating to a tradename with an estimated useful life of one year. The financial information of Medifax has been included in the financial statements of the Company from December 22, 2003, the closing date of the acquisition, and is included in the Transaction Services segment.

On September 25, 2003, the Company completed its acquisition of a privately held dental clearinghouse based in Hartford, Connecticut. The Company paid \$5,805 in cash for all of the outstanding capital stock of the acquired company and agreed to pay up to an additional \$4,200 beginning in 2005 if certain revenue related milestones are achieved. The additional payment may be made over a three-year period by issuing shares of the Company's common stock or in cash. The additional payment may exceed \$4,200 if all or a portion of the additional payment is made by issuing shares of the Company's stock and if the value of the Company's stock exceeds certain price levels. The acquisition was accounted for using the purchase method of accounting and, accordingly, the purchase price was allocated to the tangible and intangible assets acquired and the liabilities assumed on the basis of their respective fair values. In connection with the allocation of the purchase price, goodwill of \$3,482 and an intangible asset subject to amortization of \$2,392 were recorded. The Company does not expect that the goodwill or intangible assets will be deductible for tax purposes. The intangible asset is acquired technology with an estimated useful

**Table of Contents**

**WEBMD CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

life of five years. The financial information of the acquired company has been included in the financial statements of the Company from September 25, 2003, the closing date of the acquisition, and is included in the Transaction Services segment.

On July 17, 2003, the Company completed its acquisition of Advanced Business Fulfillment, Inc. ( ABF ), a privately held company based in St. Louis, Missouri. ABF provides healthcare paid-claims communications services for third-party administrators and health insurers. ABF's services allow its customers to outsource print-and-mail activities for the distribution of checks, remittance advice and explanations of benefits. The total purchase consideration for ABF was approximately \$112,891, comprised of \$108,368 in cash and \$4,523 of acquisition costs for all of the outstanding capital stock of ABF. Additionally, the Company agreed to pay up to an additional \$150,000 beginning in April 2004 if certain financial milestones are achieved. The additional payment may be made over a three-year period by issuing shares of the Company's common stock or, at the Company's option in certain circumstances, in cash. The additional payment may exceed \$150,000 if all or a portion of the additional payment is made by issuing shares of the Company's stock and if the value of the Company's stock exceeds certain price levels at the time of payment. During April 2004, the Company paid \$17,455 in cash as a result of the achievement of certain financial milestones. This payment resulted in an increase to goodwill. The acquisition was accounted for using the purchase method of accounting and, accordingly, the purchase price was allocated to the tangible and intangible assets acquired and the liabilities assumed on the basis of their respective fair values. In connection with the allocation of the purchase price, goodwill of \$61,128 and intangible assets subject to amortization of \$47,000 were recorded. The Company expects that substantially all of the goodwill recorded will be deductible for tax purposes. The intangible assets are comprised of \$41,000 relating to customer relationships with estimated useful lives of ten years, \$4,900 relating to acquired unpatented technologies with estimated useful lives of nine months to six years and \$1,100 relating to a trade name with an estimated useful life of three years. The financial information of the acquired company has been included in the financial statements of the Company from July 17, 2003, the closing date of the acquisition, and is included in the Transaction Services segment.

On May 29, 2003, the Company acquired The Little Blue Book ( LBB ), a company which maintains a database containing practice information for over 380,000 physicians, and publishes a pocket-sized reference book containing physician information. The total purchase consideration for LBB was approximately \$10,535, comprised of \$10,400 in cash and acquisition costs of \$135. Additionally, the Company will pay up to \$2,500 if LBB meets certain financial milestones during the years ending December 31, 2003 and 2004. During April 2004, the Company paid \$1,500 in cash as a result of the achievement of certain financial milestones. This payment resulted in an increase to goodwill. The acquisition was accounted for using the purchase method of accounting and, accordingly, the purchase price was allocated to the tangible and intangible assets acquired and the liabilities assumed on the basis of their respective fair values. In connection with the allocation of the purchase price, goodwill of \$8,545 and intangible assets subject to amortization of \$2,815 were recorded. The Company expects that substantially all of the goodwill recorded will be deductible for tax purposes. The intangible assets are comprised of \$1,787 relating to a trade name with an estimated useful life of seven years, \$761 relating to customer relationships with estimated useful lives of five years and \$267 relating to acquired technology with an estimated useful life of three years. The financial information of LBB has been included in the financial statements of the Company from May 29, 2003, the closing date of the acquisition, and is included in the Portal Services segment.

On April 30, 2003, the Company acquired the assets and assumed certain liabilities of a company which provides healthcare benefit decision support tools and solutions to its clients through online technology. The total purchase consideration for this acquisition was approximately \$4,052, comprised of \$4,000 in cash and acquisition costs of \$52. The acquisition was accounted for using the purchase method of accounting and, accordingly, the purchase price was allocated to the tangible and intangible assets

**Table of Contents****WEBMD CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

acquired and the liabilities assumed on the basis of their respective fair values. In connection with the allocation of the purchase price, goodwill of \$4,070 and an intangible asset subject to amortization of \$710 were recorded. The Company expects that substantially all of the goodwill recorded will be deductible for tax purposes. The intangible asset represents the fair value of customer relationships with estimated useful lives of five years. The financial information of the acquired business has been included in the financial statements of the Company from April 30, 2003, the closing date of the acquisition, and is included in the Portal Services segment.

In 2003, the Company acquired seven practice services companies for an aggregate cost of \$2,182, which was paid in cash. Additionally, the Company has agreed to pay up to \$675 beginning in 2004 if some of the acquired companies meet certain financial milestones. During the three months ended September 30, 2004, the Company paid \$50 in cash as a result of the achievement of certain financial milestones. These acquisitions were accounted for using the purchase method of accounting and, accordingly, the purchase prices were allocated to assets acquired and liabilities assumed based on their respective fair values. In connection with the allocation of the purchase prices, goodwill of \$1,519 and intangible assets subject to amortization of \$1,054 were recorded. The Company expects that substantially all of the goodwill recorded will be deductible for tax purposes. The intangible assets are comprised of \$351 related to non-compete agreements with estimated useful lives of three to five years and \$703 related to customer relationships with estimated useful lives of nine years. The financial information of these companies has been included in the financial statements of the Company from the respective acquisition closing dates and is included in the Physician Services segment.

**Unaudited Pro Forma Information**

The following unaudited pro forma financial information for the nine months ended September 30, 2004 and 2003 gives effect to the acquisitions of ABF, Medifax and ViPS, including the amortization of intangible assets, as if they had occurred on January 1, 2003. The information is provided for illustrative purposes only and is not necessarily indicative of the operating results that would have occurred if the transactions had been consummated on the date indicated, nor is it necessarily indicative of future operating results of the consolidated companies, and should not be construed as representative of these results for any future period. The remaining acquisitions in 2004 and 2003 have been excluded as the pro forma impact of such acquisitions was not significant to the nine months ended September 30, 2004 and September 30, 2003.

	Nine Months Ended September 30, 2004	Nine Months Ended September 30, 2003
Revenue	\$ 892,048	\$ 833,200
Income from continuing operations	\$ 22,455	\$ 14,050
Net income (loss)	\$ 22,455	\$ (19,561)
Basic income (loss) per common share:		
Income from continuing operations	\$ 0.07	\$ 0.05
Net income (loss)	\$ 0.07	\$ (0.06)
Diluted income (loss) per common share:		
Income from continuing operations	\$ 0.07	\$ 0.04
Net income (loss)	\$ 0.07	\$ (0.06)

**Significant Transactions**

As more fully discussed in Note 3 to the consolidated financial statements contained in the Company's 2003 Annual Report on Form 10-K, the Company entered into an agreement for a strategic



**Table of Contents****WEBMD CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

alliance with Time Warner, Inc. in May 2001. Under the agreement, the Company is the primary provider of healthcare content, tools and services for use on certain America Online properties. The original term of the agreement was for three years, ending in May 2004. The Company had a right to extend the agreement for an additional three-year term if the Company's revenue share did not exceed certain thresholds during the original three-year term. These thresholds were not met and the Company exercised its right to extend the contract term until May 2007. Under the terms of the extension, the Company's revenue share will be subject to a minimum annual guarantee.

As more fully discussed in Note 3 to the consolidated financial statements contained in the Company's 2003 Annual Report on Form 10-K, the Company entered into a strategic relationship with Microsoft in April 2001, including an agreement to program the MSN health channel. That agreement has been amended to change the expiration date from June 30, 2004 to December 31, 2004.

**3. Discontinued Operations**

On August 1, 2003, the Company completed the sale of two operating units of Porex, Porex Bio Products, Inc. ( Porex Bio ) and Porex Medical Products, Inc. ( Porex Medical ) to enable Porex to focus on its porous materials businesses. Accordingly, the historical financial information of these operating units has been reclassified as discontinued operations in the accompanying consolidated financial statements for the prior year period. The operating units were sold in two separate transactions for an aggregate sales price of \$46,500. An impairment charge of \$33,113 was recorded in the results for the quarter ended June 30, 2003 to reduce the long-lived assets of Porex Bio and Porex Medical to fair value. The write-down consisted of \$27,564 of goodwill, \$4,162 of trade name and patent intangibles and \$1,387 of other long-lived assets consisting primarily of manufacturing equipment. The impairment charge was based on the fair value of the divested businesses as determined by the expected proceeds from disposition. During the three months ended September 30, 2003, the Company recorded a loss on disposal of \$3,491, primarily representing certain costs related to the disposition. Summarized operating results for the discontinued units through August 1, 2003 were as follows:

	<b>For the Period July 1, 2003 through August 1, 2003</b>	<b>For the Period January 1, 2003 through August 1, 2003</b>
Revenue	\$ 4,739	\$ 31,004
Income (loss) from operations	\$ 125	\$(30,120)
Loss on disposal	\$(3,491)	\$ (3,491)
Loss from discontinued operations	\$(3,366)	\$(33,611)

**4. Restructuring and Integration Charge**

After the mergers with Medical Manager Corporation, CareInsite, Inc. and OnHealth Network Company in September 2000, the Company's Board of Directors approved a restructuring and integration plan, with the objective of eliminating duplication and redundancies that resulted from these and certain prior acquisitions and consolidating the Company's operational infrastructure. The Company's restructuring and integration efforts continued in 2001, and a plan to include the impact of eliminating functions resulting from the Company's acquisition of Medscape in December 2001 was initiated. During the three months ended September 30, 2004, the Company recorded an incremental restructuring charge, with respect to the 2000 restructuring plan, of \$4,535 in connection with the settlement of a lawsuit against the landlord of a property that the Company leased in 2000, but never occupied, for its then Santa Clara, California operations. The remainder of the settlement cost was previously expensed as part of the 2000



**Table of Contents**

**WEBMD CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

restructuring plan. Under the terms of the settlement, the original lease, which provided for aggregate remaining lease payments of approximately \$45,000 over the next eight years, was terminated and the Company will make a cash payment to the landlord of approximately \$23,000 during the three months ending December 31, 2004. The Company's remaining obligations related to its 2000 and 2001 restructuring plans are not material to the Company's financial position and have been included in accrued expenses in the accompanying consolidated balance sheet.

**5. Convertible Redeemable Exchangeable Preferred Stock**

On March 19, 2004, the Company issued \$100,000 of Convertible Redeemable Exchangeable Preferred Stock (the Preferred Stock) in a private transaction to CalPERS/ PCG Corporate Partners, LLC (CalPERS/ PCG Corporate Partners). CalPERS/ PCG Corporate Partners is a private equity fund managed by the Pacific Corporate Group and principally backed by California Public Employees Retirement System, or CalPERS.

The Preferred Stock has a liquidation preference of \$100,000 in the aggregate and is convertible into 10,638,297 shares of the Company's common stock in the aggregate, representing a conversion price of \$9.40 per share of common stock. The Company may not redeem the Preferred Stock prior to March 2007. Thereafter, the Company may redeem any portion of the Preferred Stock at 105% of its liquidation preference; provided that any redemption by the Company prior to March 2008 shall be subject to the condition that the average closing sale prices of the Company's common stock is at least \$13.16 per share, subject to adjustment. The Company is required to redeem all shares of the Preferred Stock then outstanding in March 2012, at a redemption price equal to the liquidation preference of the Preferred Stock, payable in cash or, at the Company's option, in shares of the Company's common stock.

If the average closing sales price of the Company's common stock during the three-month period ended on the fourth anniversary of the issuance date is less than \$7.50 per share, holders of the Preferred Stock will have a right to exchange the Preferred Stock into the Company's 10% Subordinated Notes (10% Notes) due March 2010. The 10% Notes may be redeemed, in whole or in part, at any time thereafter at the Company's option at a price equal to 105% of the principal amount of the 10% Notes being redeemed.

Holders of the Preferred Stock will not receive any dividends unless the holders of common stock do, in which case holders of the Preferred Stock will be entitled to receive ordinary dividends in an amount equal to the ordinary dividends the holders of the Preferred Stock would have received had they converted such Preferred Stock into common stock immediately prior to the record date for such dividend distribution. So long as the Preferred Stock remains outstanding, the Company is required to pay to CalPERS/ PCG Corporate Partners, on a quarterly basis, an aggregate annual fee of 0.35% of the face amount of the then outstanding Preferred Stock.

Holders of the Preferred Stock have the right to vote, together with the holders of the Company's common stock on an as converted to common stock basis, on matters that are put to a vote of the holders common stock. The Certificate of Designations for the Preferred Stock also provides that the Company will not, without the prior approval of holders of 75% of the shares of Preferred Stock then outstanding, voting as a separate class, issue any additional shares of the Preferred Stock, or create any other class or series of capital stock that ranks senior to or on a parity with the Preferred Stock.

**6. Convertible Subordinated Notes**

*1.75% Convertible Subordinated Notes Due 2023*

On June 25, 2003, the Company issued \$300,000 aggregate principal amount of 1.75% Convertible Subordinated Notes due 2023 (the 1.75% Notes) in a private offering. On July 7, 2003, the Company



**Table of Contents**

**WEBMD CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

issued an additional \$50,000 aggregate principal amount of the 1.75% Notes. Unless previously redeemed or converted, the 1.75% Notes will mature on June 15, 2023. Interest on the 1.75% Notes accrues at the rate of 1.75% per annum and is payable semiannually on June 15 and December 15, commencing December 15, 2003. The Company will also pay contingent interest of 0.25% per annum of the average trading price of the 1.75% Notes during specified six-month periods, commencing on June 20, 2010, if the average trading price of the 1.75% Notes for specified periods equals 120% or more of the principal amount of the 1.75% Notes.

The 1.75% Notes are convertible into an aggregate of 22,742,040 shares of the Company's common stock (representing a conversion price of \$15.39 per share) if the sale price of the Company's common stock exceeds 120% of the conversion price for specified periods and in certain other circumstances. The 1.75% Notes are redeemable by the Company after June 15, 2008 and prior to June 20, 2010, subject to certain conditions, including the sale price of the Company's common stock exceeding certain levels for specified periods. If the 1.75% Notes are redeemed by the Company during this period, the Company will be required to make additional interest payments. After June 20, 2010, the 1.75% Notes are redeemable at any time for cash at 100% of their principal amount. Holders of the 1.75% Notes may require the Company to repurchase their 1.75% Notes on June 15, 2010, June 15, 2013 and June 15, 2018, for cash at 100% of the principal amount of the 1.75% Notes, plus accrued interest. Upon a change in control, holders may require the Company to repurchase their 1.75% Notes for, at the Company's option, cash or shares of the Company's common stock, or a combination thereof, at a price equal to 100% of the principal amount of the 1.75% Notes being repurchased.

The Company incurred issuance costs related to the 1.75% Notes of approximately \$10,875, which are included in other assets in the accompanying consolidated balance sheets. The issuance costs are being amortized to interest expense in the accompanying consolidated statements of operations, using the effective interest method over the period from issuance through June 15, 2010, the earliest date on which holders can demand redemption.

*3 1/4% Convertible Subordinated Notes Due 2007*

On April 1, 2002, the Company issued \$300,000 aggregate principal amount of 3 1/4% Convertible Subordinated Notes due 2007 (the 3 1/4% Notes) in a private offering. Interest on the 3 1/4% Notes accrues at the rate of 3 1/4% per annum and is payable semiannually on April 1 and October 1. Unless previously redeemed or converted, the 3 1/4% Notes will mature on April 1, 2007. At the time of issuance, the 3 1/4% Notes were convertible into an aggregate of approximately 32,386,916 shares of the Company's common stock (representing a conversion price of \$9.26 per share), subject to adjustment in certain circumstances. During the three months ended June 30, 2003, \$1 principal amount of the 3 1/4% Notes was converted into 107 shares of the Company's common stock in accordance with the provisions of the 3 1/4% Notes. As of September 30, 2004, the 3 1/4% Notes were convertible into an aggregate of approximately 32,386,808 shares of the Company's common stock. The 3 1/4% Notes are redeemable at the Company's option, at any time on or after April 5, 2005. The redemption price, as a percentage of principal amount, is 101.3% beginning April 5, 2005 and 100.65% beginning April 1, 2006.

The Company incurred issuance costs related to the 3 1/4% Notes of \$8,000, which are included in other assets in the accompanying consolidated balance sheets. The issuance costs are being amortized using the effective interest method over the term of the 3 1/4% Notes. The amortization of the issuance costs is included in interest expense in the accompanying consolidated statements of operations.

**Table of Contents**

**WEBMD CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**7. Stockholders Equity**

*Preferred Stock*

On September 23, 2004, two related proposals were approved at the Company's annual meeting of stockholders. The first proposal reduced the number of authorized shares of the Company's Convertible Redeemable Exchangeable Preferred Stock from 5,000,000 to 10,000 (the amount outstanding). The other proposal authorized the Company's Board of Directors to approve the issuance of up to 4,990,000 shares of preferred stock from time to time in one or more series, to establish from time to time the number of shares to be included in any such series, and to fix the designation, powers, preferences and rights of the shares of each such series and the qualifications, limitations and restrictions thereof. No shares have been issued pursuant to that authority and the 10,000 shares of Convertible Redeemable Exchangeable Preferred Stock are the only shares of preferred stock of the Company that are outstanding.

*Stock Repurchase Program*

On March 29, 2001, the Company announced a stock repurchase program (the Program). Under the Program, the Company was originally authorized to use up to \$50,000 to purchase shares of its common stock from time to time beginning on April 2, 2001, subject to market conditions. The maximum aggregate amount of purchases under the Program was subsequently increased to \$100,000, \$150,000 and \$200,000 on November 2, 2001, November 7, 2002 and August 19, 2004, respectively. As of September 30, 2004, the Company had repurchased a total of 25,130,962 shares at a cost of approximately \$128,625 under the Program, of which 2,817,606 shares were repurchased during the nine months ended September 30, 2004 for an aggregate purchase price of \$22,267 and 2,271,356 shares were repurchased during the three months ended September 30, 2004 for an aggregate purchase price of \$17,390. As of September 30, 2003, the Company had repurchased a total of 22,060,656 shares at a cost of approximately \$104,167 under the Program, of which 2,069,496 shares were repurchased during the nine months ended September 30, 2003 for an aggregate purchase price of \$18,125. No shares were repurchased during the three months ended September 30, 2003. These repurchased shares are reflected as treasury stock in the accompanying consolidated balance sheets. As of September 30, 2004, the Company had \$71,375 available to repurchase shares of its common stock under the Program.

**8. Segment Information**

Segment information has been prepared in accordance with the Statement of Financial Accounting Standards No. 131, Disclosures about Segments of an Enterprise and Related Information (SFAS No. 131). The accounting policies of the segments are consistent with those described in the summary of significant accounting policies in Note 1 to the consolidated financial statements contained in the Company's 2003 Annual Report on Form 10-K. Inter-segment revenues represent sales of Transaction Services products into the Physician Services customer base and are reflected at rates comparable to those charged to third parties for comparable products. The performance of the Company's business is monitored based on income or loss before restructuring, taxes, non-cash and other items. Non-cash and other items include depreciation, amortization, gain on investments, other income, costs and expenses related to the investigation by the United States Attorney for the District of South Carolina and the SEC (legal expense), non-cash expenses related to content, advertising and distribution services acquired in exchange for the Company's equity securities in acquisitions and strategic alliances, and stock compensation expense primarily related to stock options issued and assumed in connection with acquisitions and restricted stock issued to employees.

**Table of Contents**

**WEBMD CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The Company has aligned its business into four operating segments as follows:

*Transaction Services or WebMD Business Services* (formerly known as WebMD Envoy) provides healthcare reimbursement cycle management services for healthcare providers and claims management services for healthcare payers, together with related technology solutions. WebMD Business Services transmits transactions electronically between healthcare payers and providers and provides healthcare payers with transaction processing technology, decision support solutions, consulting services and outsourcing services, including document management services for transaction processing and print-and-mail services for the distribution of checks, remittance advice and explanation of benefits. WebMD Business Services also provides automated patient billing services to healthcare providers, including statement printing and mailing services.

*Physician Services or WebMD Practice Services* develops and markets integrated physician practice management systems, including administrative, financial and clinical applications and services, under The Medical Manager, Intergy, ULTIA and Medical Manager Network Services brands. These systems and services allow physician offices to automate their scheduling, billing and other administrative tasks, to transmit transactions electronically, to maintain electronic medical records and to automate documentation of patient encounters.

*Portal Services or WebMD Health* provides online healthcare information, educational services and related resources for consumers, both directly and through its relationships with leading general consumer Internet portals. WebMD Health, through its Medscape subsidiary, also provides online healthcare information, educational programs and related resources for healthcare professionals, including online continuing medical education, or CME. WebMD Health also provides online content for use by media and healthcare partners on their Web sites. WebMD Health develops and sells online and offline channels of communication and sponsorship programs to pharmaceutical, biotech, medical device and consumer products companies. In addition, WebMD Health provides a suite of online tools and related services to employers and health plans for use by their employees and plan members.

*Plastic Technologies or Porex* develops, manufactures and distributes proprietary porous plastic products and components used in healthcare, industrial and consumer applications, as well as in finished products used in the medical device and surgical markets.

**Table of Contents****WEBMD CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Summarized financial information for each of the Company's operating segments and a reconciliation to net income (loss) are presented below:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
<b>Revenues</b>				
Transaction services	\$ 174,643	\$ 131,977	\$ 504,459	\$ 365,491
Physician services	76,924	75,487	219,703	224,295
Portal services	37,017	31,164	95,178	79,882
Plastic technologies	19,385	19,093	58,543	55,015
Inter-segment eliminations	(8,354)	(7,086)	(25,173)	(19,099)
	<u>\$ 299,615</u>	<u>\$ 250,635</u>	<u>\$ 852,710</u>	<u>\$ 705,584</u>
<b>Income (loss) before restructuring, taxes, non-cash and other items</b>				
Transaction services	\$ 31,750	\$ 21,767	\$ 90,514	\$ 68,160
Physician services	5,856	3,686	8,978	16,342
Portal services	10,040	8,712	22,208	18,922
Plastic technologies	5,823	5,690	17,140	15,857
Corporate	(15,170)	(12,809)	(42,703)	(37,652)
Interest income	4,512	6,401	14,506	16,434
Interest expense	(4,843)	(4,703)	(14,429)	(10,444)
	<u>37,968</u>	<u>28,744</u>	<u>96,214</u>	<u>87,619</u>
<b>Restructuring, taxes, non-cash and other items</b>				
Depreciation, amortization and other	(15,189)	(11,097)	(40,922)	(52,961)
Non-cash content and distribution services and stock compensation	(6,409)	(9,465)	(22,134)	(29,172)
Legal expense	(2,325)	(493)	(6,577)	(493)
Restructuring and integration charge	(4,535)		(4,535)	
Other income, net	94	3,039	578	4,340
Income tax provision	(1,435)	(1,273)	(2,979)	(3,261)
	<u>8,169</u>	<u>9,455</u>	<u>19,645</u>	<u>6,072</u>
Income from continuing operations	8,169	9,455	19,645	6,072
Loss from discontinued operations		(3,366)		(33,611)
	<u>\$ 8,169</u>	<u>\$ 6,089</u>	<u>\$ 19,645</u>	<u>\$ (27,539)</u>

**Table of Contents****WEBMD CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****9. Investments**

As of September 30, 2004 and December 31, 2003, the Company's short-term investments and marketable debt securities consisted of certificates of deposit, municipal bonds, asset backed securities, Federal Agency Notes and U.S. Treasury Notes and marketable equity securities consisted of equity investments in publicly traded companies. As of September 30, 2004 and December 31, 2003, all of the Company's marketable securities were classified as available-for-sale. The following table summarizes the amortized cost basis and estimated fair value of the Company's investments:

	September 30, 2004		December 31, 2003	
	Cost Basis	Fair Value	Cost Basis	Fair Value
Short-term investments	\$ 25,901	\$ 25,784	\$205,962	\$207,383
Marketable debt securities - long-term	514,922	515,096	445,810	451,290
Marketable equity securities - long-term	1,492	3,373	1,773	4,744

The amortized cost and estimated fair value by maturity of securities are shown in the following table. Securities are classified according to their contractual maturities without consideration of principal amortization, potential prepayments or call options. Accordingly, actual maturities may differ from contractual maturities.

	Cost or Amortized Cost	Fair Value
Due in one year or less	\$ 25,901	\$ 25,784
Due after one year through five years	514,922	515,096
Total	\$540,823	\$540,880

**10. Comprehensive Income (Loss)**

Comprehensive income (loss) is comprised of net income (loss) and other comprehensive income (loss). Other comprehensive income (loss) includes certain changes in equity that are excluded from net income (loss), such as changes in unrealized holding gains (losses) on available-for-sale marketable securities and foreign currency translation adjustments. The following table presents the components of other comprehensive income (loss) for the three and nine months ended September 30, 2004 and 2003:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Foreign currency translation gains (losses)	\$ 233	\$ 109	\$ (116)	\$ 1,621
Unrealized losses on securities:				
Unrealized holding gains (losses)	3,321	3,043	(7,477)	1,415
Less: reclassification adjustment for net gains realized in net income (loss)	94	3,039	457	3,222

Edgar Filing: WEBMD CORP /NEW/ - Form 10-Q

Net unrealized gains (losses) on securities	3,227	4	(7,934)	(1,807)
Other comprehensive income (loss)	3,460	113	(8,050)	(186)
Net income (loss)	8,169	6,089	19,645	(27,539)
Comprehensive income (loss)	\$ 11,629	\$ 6,202	\$ 11,595	\$ (27,725)

The foreign currency translation gains (losses) are not currently adjusted for income taxes as they relate to permanent investments in non-U.S. subsidiaries.

**Table of Contents****WEBMD CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****11. Goodwill and Other Intangible Assets**

The changes in the carrying amount of goodwill for the year ended December 31, 2003 and the nine months ended September 30, 2004 are as follows:

	<u>Transaction Services</u>	<u>Physician Services</u>	<u>Portal Services</u>	<u>Plastic Technologies</u>	<u>Total</u>
Balance as of January 1, 2003	\$ 341,967	\$ 182,085	\$ 23,705	\$ 38,286	\$ 586,043
Goodwill recorded during the period	244,021	1,469	12,731		258,221
Adjustments to finalize purchase price allocations		(745)	407		(338)
Effects of exchange rates				522	522
	<u>585,988</u>	<u>182,809</u>	<u>36,843</u>	<u>38,808</u>	<u>844,448</u>
Balance as of December 31, 2003	585,988	182,809	36,843	38,808	844,448
Goodwill recorded during the period	112,177	50	1,500	2,024	115,751
Adjustments to finalize purchase price allocations	(321)		(116)		(437)
Effects of exchange rates				37	37
	<u>\$ 697,844</u>	<u>\$ 182,859</u>	<u>\$ 38,227</u>	<u>\$ 40,869</u>	<u>\$ 959,799</u>
Balance as of September 30, 2004	\$ 697,844	\$ 182,859	\$ 38,227	\$ 40,869	\$ 959,799

Intangible assets subject to amortization consisted of the following as of September 30, 2004 and December 31, 2003:

	<u>September 30, 2004</u>			<u>December 31, 2003</u>		
	<u>Gross Carrying Amount</u>	<u>Accumulated Amortization</u>	<u>Net</u>	<u>Gross Carrying Amount</u>	<u>Accumulated Amortization</u>	<u>Net</u>
Customer lists	\$ 386,004	\$ (214,785)	\$ 171,219	\$ 325,160	\$ (206,163)	\$ 118,997
Trade names	30,716	(24,902)	5,814	30,316	(19,756)	10,560
Technology and patents	235,918	(152,332)	83,586	191,318	(146,905)	44,413
Non-compete agreements	11,560	(1,753)	9,807	11,019	(859)	10,160
	<u>\$ 664,198</u>	<u>\$ (393,772)</u>	<u>\$ 270,426</u>	<u>\$ 557,813</u>	<u>\$ (373,683)</u>	<u>\$ 184,130</u>
Total	\$ 664,198	\$ (393,772)	\$ 270,426	\$ 557,813	\$ (373,683)	\$ 184,130

Amortization expense was \$7,949 and \$20,089 for the three and nine months ended September 30, 2004, respectively, and \$3,553 and \$32,811 for the three and nine months ended September 30, 2003, respectively. Aggregate amortization expense for intangible assets is estimated to be:

Edgar Filing: WEBMD CORP /NEW/ - Form 10-Q

Year ending December 31, 2004 (October 1st to December 31st)	9,354
2005	32,896
2006	29,670
2007	28,859
2008	28,372
Thereafter	141,275



**Table of Contents**

**WEBMD CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**12. Commitments and Contingencies**

The United States Attorney for the District of South Carolina is conducting an investigation of the Company. Based on the information available to the Company as of the date of this Quarterly Report, the Company believes that the investigation relates principally to issues of financial accounting improprieties for Medical Manager Corporation, a predecessor of the Company (by its merger into the Company in September 2000), and the Company's Medical Manager Health Systems subsidiary; however, the Company cannot be sure of the investigation's exact scope or how long it may continue. The Company intends to continue to fully cooperate with the authorities in this matter. The Company understands that the SEC is also conducting a formal investigation into this matter. While the Company is not able to estimate, at this time, the amount of the expenses that it will incur in connection with the investigations, it expects that they may continue to be significant. For the three and nine months ended September 30, 2004, those expenses are reflected as Legal Expense in the accompanying consolidated statements of operations.

In the normal course of business, the Company and its subsidiaries are involved in various other claims and legal proceedings. While the ultimate resolution of these matters, including those discussed in Part II, Item 1 of this Quarterly Report and in the Company's 2003 Annual Report on Form 10-K under the heading Legal Proceedings, has yet to be determined, the Company does not believe that their outcome will have a material adverse effect on the Company's consolidated financial position or results of operations.

## **Table of Contents**

### **ITEM 2. *Management's Discussion and Analysis of Financial Condition and Results of Operations***

*This Item 2 contains forward-looking statements with respect to possible events, outcomes or results that are, and are expected to continue to be, subject to risks, uncertainties and contingencies, including those identified in this Item. See Cautionary Statement Regarding Forward-Looking Statements on page 3.*

#### **Overview**

Management's discussion and analysis of financial condition and results of operations, or MD&A, is provided as a supplement to the consolidated financial statements and notes thereto included elsewhere in this Quarterly Report and to provide an understanding of our results of operations, financial condition, and changes in financial condition. Our MD&A is organized as follows:

*Introduction.* This section provides a general description of WebMD, a brief discussion of our operating segments and background information on certain trends, strategies and other matters discussed in this MD&A.

*Critical Accounting Policies and Estimates.* This section discusses those accounting policies that both are considered important to our financial condition and results of operations, and require us to exercise subjective or complex judgments in their application. In addition, all of our significant accounting policies, including our critical accounting policies, are summarized in Note 1 to the Consolidated Financial Statements contained in our 2003 Annual Report on Form 10-K filed with the Securities and Exchange Commission.

*Results of Operations and Results of Operations by Operating Segment.* These sections provide our analysis and outlook for the significant line items on our consolidated statements of operations, on both a company-wide and a segment-by-segment basis.

*Liquidity and Capital Resources.* This section provides an analysis of our liquidity and cash flows, as well as a discussion of our outstanding debt and commitments, that existed as of September 30, 2004.

*Factors That May Affect Our Future Financial Condition or Results of Operations.* This section describes circumstances or events that could have a negative effect on our financial condition or results of operations, or that could change, for the worse, existing trends in some or all of our businesses. The factors discussed in this section are in addition to factors that may be described elsewhere in this Quarterly Report.

#### **Introduction**

WebMD Corporation is a Delaware corporation that was incorporated in December 1995 and commenced operations in January 1996 as Healthon Corporation. We changed our name to Healthon/ WebMD Corporation in November 1999 and to WebMD Corporation in September 2000. Our common stock has traded on the Nasdaq National Market under the symbol HLTH since February 11, 1999.

#### *Operating Segments*

We have aligned our business into four operating segments as follows:

*Transaction Services or WebMD Business Services (formerly known as WebMD Envoy).* We provide healthcare reimbursement cycle management services for healthcare providers and claims management services for healthcare payers, together with related technology solutions. We transmit transactions electronically between healthcare payers and providers and provide healthcare payers with transaction processing technology, decision support solutions, consulting services and outsourcing services, including document management services for transaction processing and print-and-mail services for the distribution of checks, remittance advice and explanation of benefits. We

**Table of Contents**

also provide automated patient billing services to healthcare providers, including statement printing and mailing services.

*Physician Services or WebMD Practice Services.* We develop and market integrated physician practice management systems, including administrative, financial and clinical applications and services, under The Medical Manager, Intergy, ULTIA and Medical Manager Network Services brands. These systems and services allow physician offices to automate their scheduling, billing and other administrative tasks, to transmit transactions electronically, to maintain electronic medical records and to automate documentation of patient encounters.

*Portal Services or WebMD Health.* We provide online healthcare information, educational services and related resources for consumers, both directly and through our relationships with leading general consumer Internet portals. WebMD Health, through its Medscape subsidiary, also provides online healthcare information, educational programs and related resources for healthcare professionals, including online continuing medical education, or CME. We also provide online content for use by media and healthcare partners in their Web sites. We develop and sell online and offline channels of communication and sponsorship programs to pharmaceutical, biotech, medical device and consumer products companies. In addition, we provide a suite of online tools and related services to employers and health plans for use by their employees and plan members.

*Plastic Technologies or Porex.* We develop, manufacture and distribute proprietary porous plastic products and components used in healthcare, industrial and consumer applications, as well as in finished products used in the medical device and surgical markets.

*Background Information on Certain Trends and Strategies*

*Implementation of the HIPAA Transaction Standards.* Under the Healthcare Insurance Portability and Accountability Act of 1996, or HIPAA, Congress mandated a package of interlocking administrative simplification rules, including rules to establish standards and requirements for the electronic transmission of certain healthcare transactions, which we refer to as the Transaction Standards. The compliance date for the Transaction Standards was October 16, 2003. The Transaction Standards are applicable to the portions of our business involving the processing of healthcare transactions among physicians, payers, patients and other healthcare industry participants, including WebMD Business Services and Medical Manager Network Services. In order to implement the Transaction Standards, WebMD Business Services has made and continues to make significant changes to its systems and the software it uses internally. Similarly, the implementation has required payers and providers to simultaneously implement changes to their systems and/or internal procedures. As a result, this implementation process and related testing has been an immense challenge for the healthcare industry, including WebMD. As a leading clearinghouse for healthcare transactions and a leading vendor of physician office management information systems, WebMD has been the focus of a great deal of scrutiny in the implementation process and has received some criticism for difficulties encountered by our customers and for delays in correcting some of those problems. Given the nature and scope of the changes being implemented, the large number of healthcare industry participants involved and our position in the industry, we expected that there would be some processing problems and delays. We continue to work diligently to identify and resolve problems as they occur.

*Diversification of WebMD Business Services; Cross-Selling Opportunities.* We are continuing our efforts to transform WebMD Business Services (whose name was recently changed from WebMD Envoy) from an electronic transactions clearinghouse to a provider of healthcare reimbursement cycle management services for healthcare providers and claims management services for healthcare payers. The new name is intended to reflect this transformation, which in turn is intended to allow us to provide the benefits of economies of scale to our customers in various stages of the healthcare reimbursement cycle. In order to be more efficient, many healthcare payers are focusing upon core activities building cost-effective provider networks, marketing their services to employers, and adjudicating claims payment and are outsourcing pre- and post-adjudication administrative activities, such as printing and mailing checks and explanation of benefits and other document management activities, including conversion of paper claims to

## **Table of Contents**

electronic form. By outsourcing these services to us, payers can reduce operating costs and capital expenditures. Our acquisitions of Advanced Business Fulfillment and Medifax-EDI in 2003 and Dakota Imaging in April 2004 support our ability to provide more comprehensive business process outsourcing services. Through ViPS, which we acquired in August 2004, we provide healthcare payers with information technology solutions and related services for claims processing, provider performance measurement, quality improvement, fraud detection, disease management and predictive modeling.

We expect that, over time, the revenue and earnings from providing electronic clearinghouse services for healthcare transactions, on their own, may decline. However, we believe that the revenue and earnings of our business process outsourcing and other transaction-related services, in conjunction with our clearinghouse services, is likely to offset any such decline. We are working to cross-sell our additional services to healthcare payers. However, we believe that it is possible that, in the first half of 2005, revenue from clearinghouse services will decline faster than we are able to increase the revenue from our additional services, in part because of the length of the implementation cycle for the additional services. We intend to continue the transformation of WebMD Business Services by developing or acquiring additional transaction-related services and updating our existing ones. Our strategy is to continue to increase the value we are able to provide our payer and provider customers in all aspects of their adoption and implementation of information technology solutions for healthcare transactions.

*Introduction of New Clinical Software.* Healthcare providers record, use and share various types of clinical data about their patients, including patient histories, examination notes, lab results, medication orders and referrals. Much of this data is currently recorded in handwritten or printed form on paper records, often referred to as patient charts. As the amount of patient information maintained by a practice increases, so do the logistical challenges of moving paper charts from site to site and physician to physician. Many healthcare organizations are finding that the most promising solution to this challenge is the use of electronic medical records. These systems allow providers to share patient charts and other medical records, access them simultaneously and view them from remote locations. WebMD Practice Services has recently released a new suite of clinical software called Intergy EHR. We believe that, in light of the increasing importance of clinical software to healthcare providers, WebMD Practice Services' success in retaining existing practice management system customers and attracting new customers may depend, in substantial part, on their response to Intergy EHR.

*WebMD Health IPO.* WebMD has announced that it plans to establish WebMD Health, its Portal Services segment, as a publicly traded company. WebMD stated that, based on the recommendations of its outside advisors, WebMD has decided to take the steps necessary for a sale of approximately 10% of the equity of WebMD Health in an initial public offering. WebMD expects to file a registration statement for the WebMD Health IPO in early 2005, following the release of its year-end financial statements, subject to the Board's evaluation of market conditions at that time. WebMD does not anticipate making any decisions until after the IPO is completed regarding whether any additional equity will be sold or any other subsequent transaction will occur. WebMD's Board of Directors has formed a special committee, consisting of Martin Wygod, Mark Adler and Neil Dimick, to provide oversight of the preparations for the WebMD Health IPO.

## **Critical Accounting Policies and Estimates**

Our discussion and analysis of WebMD's financial condition and results of operations are based upon our Consolidated Financial Statements and Notes to Consolidated Financial Statements, which were prepared in conformity with U.S. generally accepted accounting principles. The preparation of the consolidated financial statements requires us to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. We base our estimates on historical experience, current business factors, and various other assumptions that we believe are necessary to form a basis for making judgments about the carrying values of assets and liabilities and disclosure of contingent assets and liabilities. We are subject to uncertainties such as the impact of future events, economic, environmental and political factors, and changes in our business environment; therefore, actual results could differ from these estimates. Accordingly, the accounting estimates used in preparation of our

## **Table of Contents**

financial statements will change as new events occur, as more experience is acquired, as additional information is obtained and as our operating environment changes. Changes in estimates are made when circumstances warrant. Such changes in estimates and refinements in estimation methodologies are reflected in reported results of operations; if material, the effects of changes in estimates are disclosed in the notes to our consolidated financial statements.

We evaluate our estimates on an ongoing basis, including those related to revenue recognition, short-term and long-term investments, deferred tax assets, income taxes, collectibility of customer receivables, prepaid content and distribution services, long-lived assets including goodwill and other intangible assets, software development costs, inventory valuation, certain accrued expenses, accruals related to our restructuring program, contingencies, litigation and the value attributed to warrants issued for services.

We believe the following reflects our critical accounting policies and our more significant judgments and estimates used in the preparation of our consolidated financial statements:

*Revenue.* Our revenue recognition policies for each reportable segment are as follows:

*Transaction Services or WebMD Business Services.* Healthcare payers and providers pay us fees for our services, generally on a per transaction basis or monthly basis. We recognize revenue as we perform the service. Healthcare payers and providers also pay us one-time implementation and annual maintenance fees. We recognize revenue from these fees ratably over the term of the respective agreements. Healthcare payers also pay us fees for utilizing our software products and related post-contract customer support agreements, which we generally recognize ratably over the term of the maintenance and license agreements. Certain governmental agencies pay us fees for software maintenance and consulting services, which we recognize as we perform those services.

*Physician Services or WebMD Practice Services.* Healthcare providers pay us one-time fees for the purchase of our practice management systems. We recognize revenue from these one-time fees when we enter into noncancelable agreements with our customers, the products have been delivered and there are no uncertainties regarding product acceptance and delivery, no significant future performance obligations exist, fees are fixed and determinable and collectability is probable. Amounts received in advance of meeting these criteria are deferred until we meet these criteria. Revenue from multiple-element software arrangements is recognized using the residual method as vendor specific objective evidence ( VSOE ) of fair value exists for the undelivered elements, but not for all of the delivered elements. The residual method requires revenue to be allocated to the undelivered elements based on the fair value of such elements, as indicated by VSOE. VSOE is based on the price charged when an element is sold separately. Healthcare providers also pay us fees for maintenance and support of their practice management system, including the hardware and software. We recognize revenue from these fees ratably over the contract period, typically in one year or less. Healthcare providers also pay us fees for transmitting transactions to payers and patients. We recognize revenue from these fees, which are generally paid on a monthly or per transaction basis, as we provide the service.

*Portal Services or WebMD Health.* Customers pay us for advertising, sponsorship, healthcare management tools, content syndication and distribution, and e-commerce transactions related to our online distribution channels and the online and offline distribution channels of our strategic partners. In addition, in connection with our Medscape portal, our customers provide funding for online education programs for healthcare professionals, including online CME. Revenue from advertising is recognized as advertisements are delivered. Revenues from sponsorship arrangements and healthcare management tools are recognized ratably over the term of the applicable agreement. Revenue from CME arrangements is recognized over the period we satisfy the minimum credit hour requirements of the applicable agreements. Revenue from fixed fee content license or carriage fees is recognized ratably over the term of the applicable agreement. E-commerce revenue is recognized when a subscriber or consumer utilizes our Internet-based services or purchases goods or services through our Web site or a Web site co-branded with one of our strategic partners. Subscription revenue, including subscription revenue from sponsorship arrangements, is recognized over the subscription

**Table of Contents**

period. When contractual arrangements contain multiple elements, revenue is allocated to the elements based on their relative fair values, determined using prices charged when elements are sold separately.

*Plastic Technologies or Porex.* We develop, manufacture and distribute porous plastic products and components. For standard products, we recognize revenue upon shipment of product, net of sales returns and allowances. For sales of certain custom products, we recognize revenue upon completion and customer acceptance. Recognition of amounts received in advance of meeting these criteria is deferred until we meet these criteria.

*Long-Lived Assets.* Our long-lived assets consist of property and equipment, goodwill and other intangible assets. Goodwill and other intangible assets arise from the acquisitions we have made. The amount assigned to intangible assets is subjective and based on our estimates of the future benefit of the intangible asset using accepted valuation techniques, such as discounted cash flow and replacement cost models. Our long-lived assets, excluding goodwill, are amortized over their estimated useful lives, which we determined based on the consideration of several factors including the period of time the asset is expected to remain in service. We evaluate the carrying value and remaining useful lives of long-lived assets, excluding goodwill, whenever indicators of impairment are present. We evaluate the carrying value of goodwill annually. We use a discounted cash flow approach to determine the fair value of goodwill. There was no impairment of goodwill noted as a result of our impairment testing in 2003.

*Investments.* Our investments, at September 30, 2004, consist principally of certificates of deposit, municipal bonds, asset-backed securities, Federal Agency Notes, U.S. Treasury Notes and equity investments in publicly traded companies. Each reporting period we evaluate the carrying value of our investments and record a loss on investments when we believe an investment has experienced a decline in value that is other than temporary. We do not recognize gains on an investment until sold. Future changes in market or economic conditions or operating results of our investments could result in gains or losses or an inability to recover the carrying value of the investments that may not be reflected in an investment's carrying value.

*Deferred Tax Assets.* Our deferred tax assets are comprised primarily of net operating loss carryforwards. At September 30, 2004, we had net operating loss carryforwards of approximately \$1.9 billion. These loss carryforwards may be used to offset taxable income in future periods, reducing the amount of taxes we might otherwise be required to pay. Due to a lack of a history of generating taxable income, we record a valuation allowance equal to 100% of our net deferred tax assets. In the event that we are able to generate taxable earnings in the future and determine it is more likely than not that we can realize our deferred tax assets, an adjustment to the valuation allowance would be made which may increase income in the period that such determination was made.

**Results of Operations**

The following table sets forth our consolidated statements of operations data and expresses that data as a percentage of revenue for the periods presented (amounts in thousands):

**Table of Contents**

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2004		2003		2004		2003	
	\$	%	\$	%	\$	%	\$	%
Revenue	299,615	100.0	250,635	100.0	852,710	100.0	705,584	100.0
Cost and expenses:								
Cost of operations	168,571	56.3	149,270	59.6	495,174	58.1	410,556	58.2
Development and engineering	14,392	4.8	11,334	4.5	38,479	4.5	32,654	4.6
Sales, marketing, general and administrative	84,762	28.3	72,450	28.9	245,054	28.7	209,917	29.8
Depreciation, amortization and other	15,189	5.1	11,097	4.4	40,922	4.8	52,961	7.5
Legal expense	2,325	0.8	493	0.2	6,577	0.8	493	0.1
Restructuring and integration charge	4,535	1.5			4,535	0.5		
Interest income	4,512	1.5	6,401	2.6	14,506	1.7	16,434	2.3
Interest expense	4,843	1.6	4,703	1.9	14,429	1.7	10,444	1.5
Other income, net	94	0.1	3,039	1.2	578	0.1	4,340	0.7
Income from continuing operations before income tax provision	9,604	3.2	10,728	4.3	22,624	2.7	9,333	1.3
Income tax provision	1,435	0.5	1,273	0.5	2,979	0.4	3,261	0.4
Income from continuing operations	8,169	2.7	9,455	3.8	19,645	2.3	6,072	0.9
Loss from discontinued operations			(3,366)	(1.4)			(33,611)	(4.8)
Net income (loss)	8,169	2.7	6,089	2.4	19,645	2.3	(27,539)	(3.9)

Revenue is derived from our four business segments: Transaction Services, Physician Services, Portal Services and Plastic Technologies. Our Transaction Services include: transaction processing for medical, dental and pharmacy claims; transaction processing technology, decision support solutions, consulting services and outsourcing services for healthcare payers, including document management services for transaction processing and print-and-mail services for the distribution of checks, remittance advice and explanation of benefits; and automated patient billing services for healthcare providers, including statement printing and mailing services. Additionally, we provide software products and related maintenance contracts to Blue Cross Blue Shield and commercial healthcare payers and we perform software maintenance and consulting services for governmental agencies. A significant portion of Transaction Services revenue is generated from the country's largest national and regional healthcare payers. Our Physician Services include sales of practice management systems, including administrative, financial and clinical applications and services, under The Medical Manager, Intergy, ULTIA and Medical Manager Network Services brands. We also sell support and maintenance services related to the hardware and software associated with our practice management systems. Portal Services include advertising, sponsorship, continuing medical education, content syndication and distribution, and e-commerce transactions through our online distribution channels and the online and offline distribution channels of our strategic partners. A significant portion of Portal Services revenue is derived from a small number of customers. Our customers include pharmaceutical companies, biotech companies, medical device companies and media companies. Portal Services also provides a suite of online tools and related services to employers and health plans for use by their employees and plan members. Our Plastic Technologies revenue includes the sale of porous plastic components used to control the flow of fluids and gases for use in healthcare, industrial and consumer applications, as well as in finished products used in the medical device and surgical markets.

Cost of operations consists of costs related to services and products we provide to customers and costs associated with the operation and maintenance of our networks. These costs include salaries and related expenses for network operations personnel and customer support personnel, telecommunication costs, maintenance of network equipment, cost of postage related to our automated print-and-mail services and paid-claims communication services, cost of hardware related to the sale of practice management systems, a portion of facilities expenses, leased personnel and facilities costs, sales commissions paid to certain distributors of our Transaction Services products and non-cash expenses related to content and distribution services. In addition, cost of operations includes raw materials, direct labor and manufacturing overhead, such as fringe benefits and indirect labor related to our Plastic Technologies segment.





**Table of Contents**

Development and engineering expense consists primarily of salaries and related expenses associated with the development of applications and services. Expenses include compensation paid to development and engineering personnel, fees to outside contractors and consultants, and the maintenance of capital equipment used in the development process.

Sales, marketing, general and administrative expense consists primarily of advertising, product and brand promotion, salaries and related expenses for sales, administrative, finance, legal, information technology, human resources and executive personnel. These expenses include items related to account management and marketing personnel, commissions, costs and expenses for marketing programs and trade shows, and fees for professional marketing and advertising services, as well as fees for professional services, costs of general insurance and costs of accounting and internal control systems to support our operations. Also included are non-cash expenses related to content and distribution services acquired in exchange for our equity securities and stock compensation expense primarily related to the amortization of deferred compensation. Content and distribution services consist of advertising, promotion and distribution services from our arrangements with News Corporation, Microsoft, AOL and other partners. Stock compensation primarily relates to deferred compensation associated with the intrinsic value of the unvested portion of stock options issued in exchange for outstanding stock options of companies we acquired in 2000, the excess of the market price over the exercise price of options granted to employees and the market price of restricted stock granted to employees.

Legal expense consists of costs and expenses related to the investigation by the United States Attorney for the District of South Carolina and the SEC.

The following discussion includes a comparison of the results of operations for the three and nine months ended September 30, 2004 to the three and nine months ended September 30, 2003. Amounts are in thousands unless otherwise noted.

*Revenues*

Revenues for the three months ended September 30, 2004 were \$299,615, compared to \$250,635 for the three months ended September 30, 2003. Each operating segment experienced growth during the three months ended September 30, 2004, compared to a year ago. The Transaction Services, Portal Services, Physician Services and Plastic Technologies segments were responsible for \$42,666, \$5,853, \$1,437 and \$292, respectively, of the revenue increase for the quarter, which was partially offset by an increase of \$1,268 in inter-segment eliminations.

Revenues for the nine months ended September 30, 2004 were \$852,710, compared to \$705,584 for the nine months ended September 30, 2003. The Transaction Services, Portal Services and Plastic Technologies segments were responsible for \$138,968, \$15,296 and \$3,528, respectively, of the revenue increase for the nine-month period, which was partially offset by a decrease in revenue of \$4,592 in Physician Services and an increase of \$6,074 in inter-segment eliminations.

Revenue from customers acquired through the 2004 Acquisitions and 2003 Acquisitions contributed \$30,050 to the overall increase in revenue of \$48,980, for the three months ended September 30, 2004, and \$109,702 to the overall increase in revenue of \$147,126, for the nine months ended September 30, 2004. For purposes of this discussion, only revenue from existing customers of the acquired business on the date of the acquisition is considered to be revenue from acquired customers. We integrate acquisitions as quickly as practicable, and only revenue recognized during the first twelve months following the quarter in which the acquisition closed is considered to be revenue from acquired customers.

**Table of Contents***Costs and Expenses*

*Cost of Operations.* Cost of operations was \$168,571 and \$495,174 for the three and nine months ended September 30, 2004, compared to \$149,270 and \$410,556 in the prior year periods. Our cost of operations represented 56.3% and 58.1% of revenues for the three and nine months ended September 30, 2004, compared to 59.6% and 58.2% for the three and nine months ended September 30, 2003. The inclusion of the Medifax operations had a favorable impact on cost of operations as a percentage of revenue for both the three and nine months ended September 30, 2004 when compared to a year ago, as Medifax products have higher gross margins than the average gross margins of other products we offer. Also favorably impacting cost of operations as a percentage of revenue for the three and nine months ended September 30, 2004, when compared to a year ago, was the impact of productivity gains as a result of streamlining our delivery and service infrastructure within the Practice Services operating segment. Partially offsetting these items for both the three and nine months ended September 30, 2004, when compared to a year ago, was the inclusion of the ABF operations which have products with lower gross margins, due to the high cost of postage associated with providing ABF's services. Additionally, we experienced higher sales commissions, as a percentage of revenue, paid to our channel partners and higher costs related to our implementation efforts with respect to the HIPAA Transaction Standards and our all-payer transaction services during the 2004 periods, when compared to a year ago. Included in cost of operations were non-cash expenses related to content and distribution services of \$104 and \$705 during the three and nine months ended September 30, 2004 compared to \$1,105 and \$1,932 during the three and nine months ended September 30, 2003, respectively.

*Development and Engineering.* Development and engineering expense was \$14,392 and \$38,479 for the three and nine months ended September 30, 2004, compared to \$11,334 and \$32,654 in the prior year periods. The increase in development and engineering expense was primarily attributable to the development and engineering expense of the Medifax and Dakota operations during both the three and nine months ended September 30, 2004 which, due to the timing of these acquisitions, were not included in our results during the respective 2003 periods. The ABF operations had a similar impact on development and engineering expense during the nine months ended September 30, 2004 compared to a year ago. Also contributing to the increase in development and engineering expenses during the 2004 periods, when compared to a year ago, is the increased investment in our product development efforts within the Practice Services operating segment.

*Sales, Marketing, General and Administrative.* Sales, marketing, general and administrative expense was \$84,762 and \$245,054 for the three and nine months ended September 30, 2004, compared to \$72,450 and \$209,917 in the prior year periods. Included in sales, marketing, general and administrative expense are non-cash expenses related to content and distribution services and stock compensation. Non-cash expenses related to content and distribution services were \$3,505 and \$14,188 for the three and nine months ended September 30, 2004, compared to \$4,970 and \$16,292 for the prior year periods. Non-cash stock compensation was \$2,800 and \$7,241 for the three and nine months ended September 30, 2004, compared to \$3,390 and \$10,948 for the prior year periods. The decrease in non-cash stock compensation is primarily related to the vesting schedules of options issued and assumed in connection with acquisitions we made in 2000, partially offset by additional compensation expense during the three and nine months ended September 30, 2004 related to restricted stock issued to certain employees in March 2004.

Sales, marketing, general and administrative expense, excluding the non-cash expenses discussed above, increased to \$78,457 and \$223,625 or 26.2% and 26.2% of revenue, for the three and nine months ended September 30, 2004, compared to \$64,090 and \$182,677, or 25.6% and 25.9% of revenue, for the prior year periods. The increase in sales, marketing, general and administrative expense for both the three and nine months ended September 30, 2004 is due to higher personnel and professional services costs related to our implementation efforts with respect to the HIPAA Transaction Standards and our all-payer transaction services and our readiness efforts related to Section 404 of the Sarbanes-Oxley Act of 2002. Partially offsetting the increase in sales, marketing, general and administrative expense, as a percentage of revenue, for both the three and nine months ended September 30, 2004 was the impact of

## **Table of Contents**

the inclusion, in 2004, of the ABF, Medifax and ViPS operations which have lower administrative expenses as a percentage of revenue than our other operations.

*Depreciation, Amortization and Other.* Depreciation, amortization and other expense increased to \$15,189 for the three months ended September 30, 2004, compared to \$11,097 in the prior year period. The increase was the result of the amortization expense of the tangible and intangible assets related to the Medifax, ViPS and Dakota acquisitions, which, due to the timing of these acquisitions, did not exist in the same period a year ago. Depreciation, amortization and other expense during the nine months ended September 30, 2004 was \$40,922 compared to \$52,961 during the nine months ended September 30, 2003. This decrease was primarily due to intangible assets relating to certain acquisitions made in 2000 becoming fully amortized since the beginning of the prior year periods. This decrease was partially offset by depreciation and amortization expense related to the tangible and intangible assets acquired through our 2004 and 2003 Acquisitions.

*Legal Expense.* Legal expense was \$2,325 and \$6,577 for the three and nine months ended September 30, 2004 compared to \$493 for both the three and nine months ended September 30, 2003. Legal expense represents the costs and expenses incurred related to the investigation by the United States Attorney for the District of South Carolina and the SEC. Over the course of the investigation, we expect that these costs and expenses may continue to be significant.

*Restructuring and Integration Charge.* Restructuring and integration charge of \$4,535 represents an incremental charge taken in connection with the settlement of a lawsuit against the landlord of a property leased in 2000, but never occupied. The remaining cost of the settlement was previously expensed in connection with the restructuring and integration plan that we announced in September 2000.

*Interest Income.* Interest income was \$4,512 and \$14,506 during the three and nine months ended September 30, 2004, compared to \$6,401 and \$16,434 in the prior year periods. This decrease was due to lower average investment balances as well as lower average interest rates.

*Interest Expense.* Interest expense was \$4,843 and \$14,429 for the three and nine months ended September 30, 2004, compared to \$4,703 and \$10,444 for the prior year periods. While interest expense was relatively unchanged for the three months ended September 30, 2004, compared to the prior year period, the increase for the nine months ended September 30, 2004, compared to the prior year period, was primarily a result of interest expense and amortization of debt issuance costs related to the 1.75% Convertible Subordinated Notes issued in June and July of 2003.

*Other Income, Net.* Other income during the three and nine months ended September 30, 2004 and 2003 primarily related to net gains on the sale of marketable securities. Included in other income during the nine months ended September 30, 2003 was a benefit of \$1,118, related to a state tax refund which applied to a pre-acquisition tax year of a company we acquired.

*Income Tax Provision.* The income tax provision of \$1,435 and \$2,979 for the three and nine months ended September 30, 2004, and \$1,273 and \$3,261 for the three and nine months ended September 30, 2003, primarily related to tax expense for operations that are profitable in certain states and foreign countries in which we do not have net operating losses to offset that income.

*Discontinued Operations.* Loss from discontinued operations during the three and nine months ended September 30, 2003 represents the operating results of the discontinued units of the Plastic Technologies segment as well as a loss of \$3,491 recognized in connection with their disposal on August 1, 2003. Included in the loss from discontinued operations during the nine months ended September 30, 2003 was an impairment charge of \$33,113 to reduce certain long-lived assets of the discontinued units to fair value.

## **Results of Operations by Operating Segment**

We evaluate the performance of our business segments based upon income or loss before restructuring, taxes, non-cash and other items. Non-cash and other items include depreciation, amortization, costs and expenses related to the investigation by the United States Attorney for the District

**Table of Contents**

of South Carolina and the SEC ( legal expense ), gain on investments, other income, non-cash expenses related to content, advertising and distribution services acquired in exchange for our equity securities in acquisitions and strategic alliances, and stock compensation expense primarily related to stock options issued and assumed in connection with acquisitions and restricted stock issued to employees. The accounting policies of the segments are consistent with those described in the summary of significant accounting policies in Note 1 to the consolidated financial statements contained in our 2003 Annual Report on Form 10-K. We record inter-segment revenues at rates comparable to those charged to third parties for comparable services. Inter-segment revenues are eliminated in consolidation.

Summarized financial information for each of our operating segments and a reconciliation to net income (loss) are presented below (amounts in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
<b>Revenues</b>				
Transaction services	\$ 174,643	\$ 131,977	\$ 504,459	\$ 365,491
Physician services	76,924	75,487	219,703	224,295
Portal services	37,017	31,164	95,178	79,882
Plastic technologies	19,385	19,093	58,543	55,015
Inter-segment eliminations	(8,354)	(7,086)	(25,173)	(19,099)
	<u>\$ 299,615</u>	<u>\$ 250,635</u>	<u>\$ 852,710</u>	<u>\$ 705,584</u>
<b>Income (loss) before restructuring, taxes, non-cash and other items</b>				
Transaction services	\$ 31,750	\$ 21,767	\$ 90,514	\$ 68,160
Physician services	5,856	3,686	8,978	16,342
Portal services	10,040	8,712	22,208	18,922
Plastic technologies	5,823	5,690	17,140	15,857
Corporate	(15,170)	(12,809)	(42,703)	(37,652)
Interest income	4,512	6,401	14,506	16,434
Interest expense	(4,843)	(4,703)	(14,429)	(10,444)
	<u>37,968</u>	<u>28,744</u>	<u>96,214</u>	<u>87,619</u>
<b>Restructuring, taxes, non-cash and other items</b>				
Depreciation, amortization and other	(15,189)	(11,097)	(40,922)	(52,961)
Non-cash content and distribution services and stock compensation	(6,409)	(9,465)	(22,134)	(29,172)
Legal expense	(2,325)	(493)	(6,577)	(493)
Restructuring and integration charge	(4,535)		(4,535)	
Other income, net	94	3,039	578	4,340
Income tax provision	(1,435)	(1,273)	(2,979)	(3,261)
	<u>8,169</u>	<u>9,455</u>	<u>19,645</u>	<u>6,072</u>
Income from continuing operations	8,169	9,455	19,645	6,072
Loss from discontinued operations		(3,366)		(33,611)
	<u>\$ 8,169</u>	<u>\$ 6,089</u>	<u>\$ 19,645</u>	<u>\$ (27,539)</u>
Net income (loss)	<u>\$ 8,169</u>	<u>\$ 6,089</u>	<u>\$ 19,645</u>	<u>\$ (27,539)</u>

The following discussion is a comparison of the results of operations for each of our operating segments for the three and nine months ended September 30, 2004 to the three and nine months ended September 30, 2003.

## Edgar Filing: WEBMD CORP /NEW/ - Form 10-Q

*Transaction Services.* Revenues were \$174,643 and \$504,459 for the three and nine months ended September 30, 2004, compared to \$131,977 and \$365,491 for the prior year periods. Revenues from customers acquired through the 2004 Acquisitions and 2003 Acquisitions contributed \$29,745 and \$107,939 to the increase for the three and nine months ended September 30, 2004. The remaining increases of \$12,921 and \$31,029 for the three and nine months ended September 30, 2004 were primarily

**Table of Contents**

the result of increased sales of our paid-claims communication services, electronic data interchange, or EDI transaction services and automated print-and-mail services.

Income before restructuring, taxes, non-cash and other items was \$31,750 and \$90,514 for the three and nine months ended September 30, 2004, an increase of \$9,983 or 45.9% and \$22,354 or 32.8%, compared to the prior year periods. As a percentage of revenue, income before restructuring, taxes, non-cash and other items increased to 18.2% for the three months ended September 30, 2004, compared to 16.5% a year ago, and decreased to 17.9% for the nine months ended September 30, 2004, compared to 18.6% a year ago. The acquisitions of Medifax, ABF and ViPS had a favorable impact on operating margins for both the three and nine months ended September 30, 2004. Offsetting the higher margins of these acquisitions were higher sales commissions paid to our channel partners and increased costs related to our implementation efforts with respect to the HIPAA Transaction Standards and our all-payer transaction services.

*Physician Services.* Revenues were \$76,924 and \$219,703 for the three and nine months ended September 30, 2004, an increase (decrease) of \$1,437 and \$(4,592) compared to the prior year periods. The increase in revenues for the three months ended September 30, 2004, compared to a year ago, is primarily due to an increase in Network Services revenue offset by lower systems sales. Network Services revenues were also higher during the nine months ended September 30, 2004, compared to a year ago, however that increase was more than offset by lower systems sales. Systems sales have been impacted by longer and more complex sales cycles and from HIPAA implementation and other transition challenges related to our all-payer transaction services. Revenue from customers acquired through the 2004 Acquisitions and 2003 Acquisitions was \$305 and \$1,263 for the three and nine months ended September 30, 2004.

Income before restructuring, taxes, non-cash and other items was \$5,856 and \$8,978 for the three and nine months ended September 30, 2004, compared to \$3,686 and \$16,342 in the prior year periods. As a percentage of revenue, income before restructuring, taxes, non-cash and other items was 7.6% and 4.1% for the three and nine months ended September 30, 2004, compared to 4.9% and 7.3% for the prior year periods. Lower systems sales combined with lower margins, particularly during the March 2004 and June 2004 quarters, were primarily responsible for the operating margin of 4.1% during the nine months ended September 30, 2004. Productivity gains combined with the increased revenues during the three months ended September 30, 2004 have resulted in an increased margin of 7.6% for this period.

*Portal Services.* Revenues were \$37,017 and \$95,178 for the three and nine months ended September 30, 2004, an increase of \$5,853 or 18.8% and \$15,296 or 19.1%, compared to the prior year periods. The increase in revenues for the three months ended September 30, 2004, compared to a year ago, is due to increased sponsorship and advertising revenue, in addition to an increase in revenues from large employers and commercial payers for our web-based health and benefit management solutions. The increase in revenues for the nine months ended September 30, 2004, compared to a year ago, is the result of growth in online revenues from pharmaceutical and medical companies and increased revenues from large employers and commercial payers. Revenues from customers acquired through the 2003 Acquisitions contributed \$500 to the increase in Portal Services revenue for the nine months ended September 30, 2004.

Income before restructuring, taxes, non-cash and other items was \$10,040 and \$22,208 for the three and nine months ended September 30, 2004, an increase of \$1,328 or 15.2% and \$3,286 or 17.4%, compared to the prior year periods. As a percentage of revenue, income before restructuring, taxes, non-cash and other items was 27.1% and 23.3% for the three and nine months ended September 30, 2004, compared to 28.0% and 23.7% for the prior year periods. The decrease as a percentage of revenue for the three and nine months ended September 30, 2004, compared to a year ago, was primarily the result of increased compensation costs offset by reduced marketing expenses.

*Plastic Technologies.* Revenues were \$19,385 and \$58,543 for the three and nine months ended September 30, 2004, compared to \$19,093 and \$55,015 for the prior year periods. The increase for the three and nine months ended September 30, 2004, compared to a year ago, was primarily due to increased

## **Table of Contents**

sales of writing instrument components and surgical products. Also contributing to the increase in revenues during the nine months ended September 30, 2004, compared to a year ago, was the favorable impact of foreign exchange rates.

Income before restructuring, taxes, non-cash and other items was \$5,823 and \$17,140 for the three and nine months ended September 30, 2004, compared to \$5,690 and \$15,857 in the prior year periods. As a percentage of revenue, income before restructuring, taxes, non-cash and other items was 30.0% and 29.3% for the three and nine months ended September 30, 2004, compared to 29.8% and 28.8% for the prior year periods. These increases as a percentage of revenue were primarily due to the leveraging effect of certain fixed manufacturing costs.

*Corporate* includes expenses shared across all operating segments, such as executive, corporate finance, legal, human resources and risk management. Corporate expenses increased to \$15,170 and \$42,703 during the three and nine months ended September 30, 2004, compared to \$12,809 and \$37,652 in the prior year periods. As a percentage of revenue, corporate expenses were 5.1% and 5.0% during the three and nine months ended September 30, 2004, compared to 5.1% and 5.3% for the same periods a year ago. While the dollar amounts of corporate expenses have increased when compared to a year ago, these expenses comprise a slightly lower percentage of revenue. Contributing to the increase in the dollar amount of these expenses, when compared to a year ago, were higher professional services costs related to our readiness efforts related to Section 404 of the Sarbanes-Oxley Act of 2002.

*Inter-Segment Eliminations.* The increase in inter-segment eliminations for the three and nine months ended September 30, 2004, compared to the prior year periods, resulted from higher sales of Transaction Services products into the Physician Services customer base.

## **Liquidity and Capital Resources**

We have incurred significant operating and net losses since we began operations and, as of September 30, 2004, we had an accumulated deficit of \$10.2 billion. We plan to continue to invest in acquisitions, strategic relationships, infrastructure and product development.

As of September 30, 2004, we had \$133,988 in cash and cash equivalents and short-term investments and working capital of \$68,212. Additionally, we had long-term investments of \$515,096 in marketable debt securities and \$3,373 in marketable equity securities. We invest our excess cash principally in U.S. Treasury obligations and Federal Agency Notes and expect to do so in the future.

Cash provided by operating activities was \$79,200 for the nine months ended September 30, 2004, compared to \$84,025 for the nine months ended September 30, 2003. The cash provided by operating activities for the nine months ended September 30, 2004 was primarily attributable to the net income of \$19,645 and non-cash charges of \$65,311, partially offset by net changes in operating assets and liabilities of \$5,178. The negative impact of changes in operating assets and liabilities may reverse in future periods, depending on the timing of each period end in relation to items such as payroll and billing cycles, payments from customers, payments to vendors, interest payments relating to our 1.75% and 3 1/4% Convertible Subordinated Notes and interest receipts relating to our investments in marketable securities. The cash provided by operating activities for the nine months ended September 30, 2003 was primarily attributable to non-cash charges of \$83,638 and the loss from discontinued operations of \$33,611, partially offset by a net loss of \$27,539 and net changes in operating assets and liabilities of \$7,593. The non-cash charges consist of depreciation and amortization, non-cash expenses related to content and distribution services, stock compensation and amortization of debt issuance costs.

Cash used in investing activities was \$140,209 for the nine months ended September 30, 2004, compared to \$530,015 for the nine months ended September 30, 2003. Cash used in investing activities for the nine months ended September 30, 2004 related to \$274,600 of purchases of available-for-sale securities and cash paid in relation to business combinations of \$225,375, net of cash acquired, offset by \$384,238 of proceeds from maturities and sales of available-for-sale securities. Cash used in investing activities for the nine months ended September 30, 2003 primarily related to \$597,867 of purchases of available-for-sale

**Table of Contents**

securities and held-to-maturity securities, partially offset by \$169,241 of proceeds from the maturities, sales and redemptions of available-for-sale securities and held-to-maturity securities. Additionally, the 2003 Acquisitions consumed cash of \$133,471, net of cash acquired. Investments in property and equipment were \$24,889 and \$13,643 for the nine months ended September 30, 2004 and 2003.

Cash provided by financing activities was \$105,943 for the nine months ended September 30, 2004, compared to \$349,610 for the nine months ended September 30, 2003. Cash provided by financing activities for the nine months ended September 30, 2004 principally related to the net proceeds of \$98,115 from the issuance of our Convertible Redeemable Exchangeable Preferred Stock and proceeds of \$30,528 primarily related to exercises of employee stock options. Cash provided by financing activities for the nine months ended September 30, 2003 primarily related to \$339,125 of net proceeds from the issuance of our 1.75% Convertible Subordinated Notes on June 25, 2003 and July 7, 2003. During the nine months ended September 30, 2004 and 2003, \$22,267 and \$18,125 was used for repurchases of our common stock.

As of September 30, 2004, we did not have any material commitments for capital expenditures. Our principal commitments at September 30, 2004 were our commitments related to the \$350,000 of 1.75% Convertible Subordinated Notes due in June of 2023, the \$299,999 of 3 1/4% Convertible Subordinated Notes due in April of 2007, our \$100,000 of Convertible Redeemable Exchangeable Preferred Stock and obligations under operating leases. Additionally, we had commitments to make potential earnout payments of up to an aggregate of \$163,400, as of September 30, 2004, related to completed acquisitions.

Since December 31, 2003, our contractual obligations, contingencies and commitments for minimum lease payment obligations under non-cancelable operating leases have increased approximately \$40,000 as a result of new operating leases related to our Tampa, Florida and New York, New York operations and approximately \$13,000 as a result of new operating leases related to our acquisitions completed in 2004. Offsetting these increases was the termination of a remaining obligation of \$45,000 relating to an operating lease for a property we leased in 2000, for our then Santa Clara, California operations. We will pay approximately \$23,000 during the three months ending December 31, 2004, in connection with the termination of the Santa Clara, California lease.

We believe that, for the foreseeable future, we will have sufficient cash resources to meet the commitments described above and our current anticipated working capital and capital expenditure requirements, including the capital requirements related to the roll-out of new or updated products in 2004 and 2005. Our future liquidity and capital requirements will depend upon numerous factors, including retention of customers at current volume and revenue levels, our existing and new application and service offerings, competing technological and market developments, potential future acquisitions and additional repurchases of our common stock. In addition, we have been incurring, and may continue to incur, costs relating to our own implementation of the HIPAA Transaction Standards and for assistance we provide to our customers in their implementation efforts. We may need to raise additional funds to support expansion, develop new or enhanced applications and services, respond to competitive pressures, acquire complementary businesses or technologies or take advantage of unanticipated opportunities. If required, we may raise such additional funds through public or private debt or equity financing, strategic relationships or other arrangements. There can be no assurance that such financing will be available on acceptable terms, if at all, or that such financing will not be dilutive to our stockholders.

As described above under Introduction Background Information on Certain Trends and Strategies WebMD Health IPO, WebMD plans to take the steps necessary for a sale of approximately 10% of the equity of WebMD Health in an initial public offering in early 2005, following the release of its year-end financial statements, subject to the WebMD Board's evaluation of market conditions at that time. WebMD does not anticipate making any decisions until after the IPO is completed regarding whether any additional equity will be sold or any other subsequent transaction will occur.



**Table of Contents**

**Factors That May Affect Our Future Financial Condition or Results of Operations**

This section describes circumstances or events that could have a negative effect on our financial results or operations or that could change, for the worse, existing trends in some or all of our businesses. The occurrence of one or more of the circumstances or events described below could have a material adverse effect on our financial condition, results of operations and cash flows or on the trading prices of the common stock and convertible notes that we have issued. The risks and uncertainties described below are not the only ones facing WebMD. Additional risks and uncertainties that are not currently known to us or that we currently believe are immaterial may also adversely affect our business and operations.

---

**Risks Related to Our Relationships with Customers and Strategic Partners**

*The financial results of WebMD Business Services could be adversely affected if payers conduct electronic data interchange, or EDI, transactions without using a clearinghouse or if their ability to do so allows them to terminate or modify their relationships with us*

There can be no assurance that healthcare payers will continue to use WebMD Business Services and other independent companies to transmit healthcare transactions. Some payers currently offer electronic data transmission services to healthcare providers that bypass third-party EDI service providers such as WebMD Business Services. In addition, some payers currently offer electronic data transmission services through affiliated clearinghouses that compete with WebMD Business Services. See We may lose customers that compete with one or more of our businesses because they perform services internally instead of using a third party provider below. We cannot provide assurance that we will be able to maintain our existing relationships with payers or develop new relationships on satisfactory terms, if at all. Although the standardization of formats and data standards required by HIPAA is only partial and we believe that use of clearinghouses will continue to be the most efficient way for most providers to transact electronically with multiple payers, such standardization may facilitate additional use of EDI links for transmission of transactions between a greater number of healthcare payers and providers without use of a clearinghouse. Any significant increase in the utilization of links between healthcare providers and payers without use of a third party clearinghouse could have a material adverse effect on WebMD Business Services transaction volume and financial results. In addition, any increase in the ability of payers to bypass third party EDI service providers may adversely affect the terms and conditions we are able to negotiate in our agreements with them, which could also have a material adverse impact on WebMD Business Services business and financial results.

*We may lose customers that compete with one or more of our businesses or because they perform services internally instead of using a third party provider*

Some of our existing payer and provider customers and some of our strategic partners may compete with us or plan to do so or belong to alliances that compete with us or plan to do so. For example, some payers currently offer, through affiliated clearinghouses, Web portals and other means, electronic data transmission services to healthcare providers that allow the provider to bypass third party EDI service providers such as WebMD Business Services. We cannot provide assurance that we will be able to maintain our existing relationships with payers or develop new relationships on satisfactory terms, if at all. In addition, some of our other services allow healthcare payers to outsource business processes that they have been or could be performing internally and, in order for us to be able to compete, use of our services must be more efficient for them than use of internal resources.

*WebMD Business Services transaction volume and financial results could be adversely affected if we do not maintain relationships with practice management system vendors and large submitters of healthcare EDI transactions*

We have developed relationships with practice management system vendors and large submitters of healthcare claims to increase the usage of our WebMD Business Services transaction services. WebMD

**Table of Contents**

Practice Services is a competitor of these practice management system vendors. These vendors, as a result of our ownership of WebMD Practice Services or for other reasons, may choose in the future to diminish or terminate their relationships with WebMD Business Services. Some other large submitters of claims compete with, or may have significant relationships with entities that compete with, WebMD Business Services or WebMD Health. To the extent that we are not able to maintain mutually satisfactory relationships with the larger practice management system vendors and large submitters of healthcare EDI transactions, WebMD Business Services' transaction volume and financial results could be adversely affected.

*Contractual relationships with governmental customers may impose special burdens on us and provide special benefits to those customers, including the right to change or terminate the contract in response to budgetary constraints or policy changes*

A portion of WebMD Business Services' revenues comes from customers that are governmental agencies. The recent acquisition of ViPS has increased that portion and we intend to seek additional government contracts and subcontracts. Government contracts may be subject to some or all of the following:

termination when appropriated funding for the current fiscal year is exhausted;

termination for the governmental customer's convenience, subject to a negotiated settlement for costs incurred and profit on work completed, along with the right to place contracts out for bid before the full contract term, as well as the right to make unilateral changes in contract requirements, subject to negotiated price adjustments;

most-favored pricing requirements to ensure that the government receives the lowest price offered to a specified class of customers and submissions of proprietary cost or pricing data to ensure that pricing is fair and reasonable;

more favorable licensing terms for software than we would ordinarily offer non-governmental customers;

reporting and compliance requirements related to, among other things: equal employment opportunity, affirmative action, and accessibility for the disabled;

broader audit rights than we would usually grant to non-governmental customers;

specialized remedies for breach and default, including setoff rights, retroactive price adjustments, and civil or criminal fraud penalties, as well as mandatory administrative dispute resolution procedures instead of state contract law remedies.

In addition, certain violations of federal law may subject U.S. government contractors to having their contracts terminated and, under certain circumstances, suspension and debarment from future U.S. government contracts. Finally, some of our governmental contracts are priced based on our cost of providing products and services. Those contracts are subject to regulatory cost-allowability standards and a specialized system of cost accounting standards.

*Lengthened sales, installation and implementation cycles for WebMD Practice Services applications may result in unanticipated fluctuations in its revenues*

WebMD Practice Services is seeking to increase its sales to larger physician groups and clinics. These sales are typically not only larger in size, but also involve more complex practice management and electronic medical records applications. As a result, we expect longer sales, contracting, installation and implementation cycles for these customers. These sales may be subject to delays due to customers' internal procedures for approving large expenditures and for deploying new technologies; implementation may be subject to delays based on the availability of the internal customer resources needed. We are unable to control many of the factors that will influence the timing of the buying decisions of potential customers or

**Table of Contents**

the pace at which installation and training may occur. Unexpected delays in these sales or in their implementation may result in unanticipated fluctuations in the revenues of WebMD Practice Services.

*WebMD Practice Services faces competition in providing support services to owners of The Medical Manager and other systems*

WebMD Practices Services faces competition for the support services it markets to owners of The Medical Manager systems, as well as for similar services that we market to owners of certain other practice management systems that we have acquired. Physician practices may seek such support from third parties, including businesses that support or manage information technology for various types of clients and businesses that specialize in systems for physicians, some of whom may formerly have been independent dealers of The Medical Manager software or of practice management systems we have acquired. We cannot provide assurance that we will be able to compete successfully against these service providers. In addition, some physician practices, especially larger ones, may use their own employees and other internal resources to support their practice management systems.

*Loss of a small number of sponsors could have a material adverse effect on WebMD Health's revenues*

A substantial portion of WebMD Health's revenues come from a relatively small number of companies. Thus, the loss of a small number of these relationships or a reduction in the purchases by a portion of these sponsors could have a material adverse effect on WebMD Health's revenues. We may lose such relationships or experience a reduction in purchases if customers decide not to renew their commitments or renew at lower levels, which may occur if we fail to meet our customers' expectations or needs or fail to keep up with our competition or for reasons outside our control, including changes in economic and regulatory conditions affecting the healthcare industry or changes specific to the businesses of particular customers. For more information, see Risks Related to Providing Products and Services to the Healthcare Industry Developments in the healthcare industry could adversely affect our business below and Business Government Regulation in our 2003 Annual Report on Form 10-K.

*Third parties may bring claims as a result of the activities of our strategic partners or resellers of our products and services*

We could be subject to claims by third parties, and to liability, as a result of the activities, products or services of our strategic partners or resellers of our products and services. Even if these claims do not result in liability to us, investigating and defending these claims could be expensive, time-consuming and result in adverse publicity that could harm our business.

---

**Risks Related to the Development and Performance of Our  
Healthcare Information Services and Technology Solutions**

*Our ability to generate revenue could suffer if we do not continue to update and improve our existing products and services and develop new ones*

We must introduce new healthcare information services and technology solutions and improve the functionality of our existing products and services in a timely manner in order to retain existing customers and attract new ones. However, we may not be successful in responding to technological and regulatory developments and changing customer needs. The pace of change in the markets we serve is rapid, and there are frequent new product and service introductions by our competitors and by vendors whose products and services we use in providing our own products and services. If we do not respond successfully to technological and regulatory changes and evolving industry standards, our products and services may become obsolete. Technological changes may also result in the offering of competitive products and services at lower prices than we are charging for our products and services, which could result in our losing sales unless we lower the prices we charge. In addition, there can be no assurance that the products we develop or license will be able to compete with the alternatives available to our customers. For more

**Table of Contents**

information about the competition we face, see Business Healthcare Information Services and Technology Solutions Competition for Our Healthcare Information Services and Technology Solutions in our 2003 Annual Report on Form 10-K.

*Developing and implementing new or updated products and services may take longer and cost more than expected*

We rely on a combination of internal development, strategic relationships, licensing and acquisitions to develop our products and services. The cost of developing new healthcare information services and technology solutions is inherently difficult to estimate. Our development and implementation of proposed products and services may take longer than originally expected, require more testing than originally anticipated and require the acquisition of additional personnel and other resources. If we are unable to develop new or updated products and services on a timely basis and implement them without significant disruptions to the existing systems and processes of our customers, we may lose potential sales and harm our relationships with current or potential customers.

*New or updated products and services will not become profitable unless they achieve sufficient levels of market acceptance*

There can be no assurance that healthcare providers and payers will accept from us new or updated products and services or products and services that result from integrating existing and/or acquired products and services. Providers and payers may choose to use similar products and services offered by our competitors if they are already using products and services of those competitors and have made extensive investments in hardware, software and training relating to those products and services. Even providers and payers who are already our customers may not purchase new or updated products or services, especially when they are initially offered. Providers and payers using our existing products and services may refuse to adopt new or updated products and services when they have made extensive investments in hardware, software and training relating to those existing products and services. In addition, there can be no assurance that any pricing strategy that we implement for any such products and services will be economically viable or acceptable to the target markets. Failure to achieve broad penetration in target markets with respect to new or updated products and services could have a material adverse effect on our business prospects.

For example, we are working to transform WebMD Business Services from a commercial claims clearinghouse to a supplier of a full complement of reimbursement cycle management solutions, including outsourcing of pre-and post-adjudication services for payer customers, sending claims transactions and receiving electronic remittance advice transactions for our provider and vendor customers, and other value-added services. However, there can be no assurance that customers who use our services for sending and receiving claims will use our other services, that our other services will attract additional customers or that such services will generate sufficient revenues to cover the costs of developing, marketing and providing those services.

*Achieving market acceptance of new or updated products and services is likely to require significant efforts and expenditures*

Achieving market acceptance for new or updated products and services is likely to require substantial marketing efforts and expenditure of significant funds to create awareness and demand by participants in the healthcare industry. In addition, deployment of new or updated products and services may require the use of additional resources for training our existing sales force and customer service personnel and for hiring and training additional salespersons and customer service personnel. There can be no assurance that the revenue opportunities from new or updated products and services will justify amounts spent for their development, marketing and roll-out.

**Table of Contents**

*We could be subject to breach of warranty, product liability or other claims if our software products, information technology systems or transmission systems contain errors or experience failures*

Undetected errors in the software and systems we provide to customers or the software and systems we use to provide services could cause serious problems for our customers. For example, errors in our transaction processing systems can result in healthcare payers paying the wrong amount or making payments to the wrong payee. If problems like these occur, our customers may seek compensation from us or may seek to terminate their agreements with us, withhold payments due to us, seek refunds from us of part or all of the fees charged under those agreements or initiate litigation or other dispute resolution procedures. We also provide products and services that assist in healthcare decision-making, including some that relate to patient medical histories and treatment plans. If these products malfunction or fail to provide accurate and timely information, we could be subject to product liability claims. In addition, we could face breach of warranty or other claims or additional development costs if our software and systems do not meet contractual performance standards, do not perform in accordance with their documentation, or do not meet the expectations that our customers have for them. Our software and systems are inherently complex and, despite testing and quality control, we cannot be certain that errors will not be found in prior versions, current versions or future versions or enhancements. See also *During times when we are making significant changes to our products and services, there are increased risks of performance problems* below.

We attempt to limit, by contract, our liability for damages arising from negligence, errors or mistakes. However, contractual limitations on liability may not be enforceable in certain circumstances or may otherwise not provide sufficient protection to us from liability for damages. We maintain liability insurance coverage, including coverage for errors and omissions. However, it is possible that claims could exceed the amount of our applicable insurance coverage or that this coverage may not continue to be available on acceptable terms or in sufficient amounts. Even if these claims do not result in liability to us, investigating and defending against them could be expensive and time consuming and could divert management's attention away from our operations. In addition, negative publicity caused by these events may delay market acceptance of our products and services, including unrelated products and services.

*Performance problems with WebMD Business Services' systems or system failures could cause us to lose customers or cause customers to reduce the number of transactions we process for them*

We process payer and provider transactions and data at our own facilities and at a data center in Tampa, Florida that is operated by an independent third party. We have contingency plans for emergencies with our systems; however, we have limited backup facilities to process information if these facilities are not functioning. The occurrence of a major catastrophic event or other system failure at any of our facilities or at the third-party facility could interrupt data processing or result in the loss of stored data, which could have a material adverse impact on our business.

Our payer and provider customer satisfaction and our business could be harmed if WebMD Business Services experiences transmission delays or failures or loss of data in its systems. WebMD Business Services' systems are complex and, despite testing and quality control, we cannot be certain that problems will not occur or that they will be detected and corrected promptly if they do occur. See also *During times when we are making significant changes to our products and services, there are increased risks of performance problems* below.

*During times when we are making significant changes to our products and services, there are increased risks of performance problems*

If we do not respond successfully to technological and regulatory changes and evolving industry standards, our products and services may become obsolete. See *Our ability to generate revenue could suffer if we do not continue to update and improve our existing products and services and develop new ones* above. The software and systems that we sell and that we use to provide services are inherently complex and, despite testing and quality control, we cannot be certain that errors will not be found in any enhancements, updates and new versions that we market or use. Even if new products and services do not

**Table of Contents**

have performance problems, our technical and customer service personnel may have difficulties in installing them or in their efforts to provide any necessary training and support to customers.

For example, we have had and may continue to have transmission or processing problems relating to implementation of the HIPAA electronic transaction and code sets standards and our all-payer suite of services. These problems included: transmission failures resulting from sending large batches of electronic transactions to non-commercial payers who have been accustomed to receiving transactions through a greater number of smaller batches; enrollment and other set-up errors resulting from initiating services to large numbers of customers simultaneously; and various other transmission, processing, interfacing and service problems resulting from the implementation of new software and new business processes.

*If our systems or the Internet experience security breaches or are otherwise perceived to be insecure, our business could suffer*

A significant security breach could damage our reputation or result in liability. We retain and transmit confidential information, including patient health information, in our processing centers and other facilities. It is critical that these facilities and infrastructure remain secure and be perceived by the marketplace as secure. We may be required to expend significant capital and other resources to protect against security breaches and hackers or to alleviate problems caused by breaches. Despite the implementation of security measures, this infrastructure or other systems that we interface with, including the Internet and related systems, may be vulnerable to physical break-ins, hackers, improper employee or contractor access, computer viruses, programming errors, attacks by third parties or similar disruptive problems. Any compromise of our security, whether as a result of our own systems or systems that they interface with, could reduce demand for our services. See also Business Government Regulation Health Insurance Portability and Accountability Act of 1996 Security Standards in our 2003 Annual Report on Form 10-K.

*Performance problems with WebMD Business Services systems could affect our relationships with customers of our Practice Services business*

WebMD Business Services provides the transaction services, including the all-payer transaction services, used by the Medical Manager Network Services customers of our Practice Services business. As an increasing number of our WebMD Practice Services customers rely on us to provide our all-payer suite of transaction services, disruptions to those services could cause some of those customers to obtain some or all of their software support requirements from competitors of ours or could cause some customers to switch to a competing physician practice management or billing software solution.

*WebMD Business Services ability to provide transaction services depends on services provided by telecommunications companies*

WebMD Business Services relies on a limited number of suppliers to provide some of the telecommunications services necessary for its transaction services. The telecommunications industry has been subject to significant changes as a result of changes in technology, regulation and the underlying economy. Recently, many telecommunications companies have experienced financial problems and some have sought bankruptcy protection. Some of these companies have discontinued telecommunications services for which they had contractual obligations to WebMD Business Services. WebMD Business Services inability to source telecommunications services at reasonable prices due to a loss of competitive suppliers could affect its ability to maintain its margins until it is able to raise its prices to its customers and, if it is not able to raise its prices, could have a material adverse effect on its financial results.

**Table of Contents**

**Risks Related to Providing Products and Services to the Healthcare Industry**

*Developments in the healthcare industry could adversely affect our business*

Almost all of the revenues of WebMD Health, WebMD Business Services and WebMD Practice Services come from customers in various parts of the healthcare industry. In addition, a significant portion of Porex's revenues come from products used in healthcare or related applications. Developments that result in a reduction of expenditures by customers or potential customers in the healthcare industry could have a material adverse effect on our business. General reductions in expenditures by healthcare industry participants could result from, among other things:

government regulation or private initiatives that affect the manner in which healthcare providers interact with patients, payers or other healthcare industry participants, including changes in pricing or means of delivery of healthcare products and services (for additional discussion of the potential effects of regulatory matters on our business and on participants in the healthcare industry, see the other Risks Related to Providing Products and Services to the Healthcare Industry described below in this section and Business Government Regulation in our 2003 Annual Report on Form 10-K);

consolidation of healthcare industry participants;

reductions in governmental funding for healthcare; and

adverse changes in business or economic conditions affecting healthcare payers or providers, pharmaceutical companies, medical device manufacturers or other healthcare industry participants.

Even if general expenditures by industry participants remain the same or increase, developments in the healthcare industry may result in reduced spending on information technology and services or in some or all of the specific segments of that market we serve or are planning to serve. For example, use of our products and services could be affected by:

changes in the billing patterns of healthcare providers;

changes in the design of health insurance plans;

changes in the contracting methods payers use in their relationships with providers; and

decreases in marketing expenditures by pharmaceutical companies or medical device manufacturers, including as a result of governmental regulation or private initiatives that discourage or prohibit promotional activities by pharmaceutical or medical device companies.

In addition, expectations of our customers regarding pending or potential industry developments may also affect their budgeting processes and spending plans with respect to products and services of the types we provide. See also Governmental and private initiatives to support adoption of healthcare information technology may encourage additional companies to enter our markets or result in the development of technology solutions that compete with ours below.

The healthcare industry has changed significantly in recent years and we expect that significant changes will continue to occur. However, the timing and impact of developments in the healthcare industry are difficult to predict. We cannot provide assurance that the markets for our products and services will continue to exist at current levels or that we will have adequate technical, financial and marketing resources to react to changes in those markets.

*Governmental and private initiatives to support adoption of healthcare information technology may encourage additional companies to enter our markets or result in the development of technology solutions that compete with ours*

There are currently numerous federal, state and private initiatives and studies seeking ways to increase the use of information technology in healthcare, including in the physician's office, as a means of

## **Table of Contents**

improving care and reducing costs. For example, the Department of Health and Human Services issued a report earlier this year entitled "The Decade of Health Information Technology: Delivering Consumer-centric and Information-rich Health Care." At WebMD, an important part of our mission has been fostering adoption of information technology and electronic communications in healthcare. Accordingly, we welcome governmental and private initiatives designed to achieve the same goals. However, these initiatives may encourage more companies to enter our markets or result in the development of technology solutions that compete with ours. The effect that these initiatives may have on our business is difficult to predict and there can be no assurances that we will adequately address the risks created by these initiatives or that we will be able to take advantage of any resulting opportunities.

*The HIPAA Transaction and Code Sets Standards creates risks and challenges with respect to our compliance efforts, business strategies and customer relationships*

*Application of the Transaction Standards to WebMD.* October 16, 2003 was the deadline for covered entities to comply with HIPAA's electronic transaction and code sets standards (which we refer to as the Transaction Standards). Failure to comply with the Transaction Standards may subject WebMD Business Services to civil monetary penalties, and possibly to criminal penalties. On July 24, 2003, the Centers for Medicare & Medicaid Services, or CMS, released its "Guidance on Compliance with HIPAA Transactions and Code Sets After the October 16, 2003 Implementation Deadline" (which we refer to as the CMS Guidance). In addition, on July 24, 2003, CMS officials participated in an "Open Door Forum" teleconference during which they provided additional clarification on planned enforcement practices. CMS also urged the adoption of "contingency plans" to help prevent disruptions in the healthcare payment system. Under CMS's contingency plan for Medicare, it will continue to accept claims in both HIPAA standard and legacy formats, with the legacy formats to be accepted for a period to be determined by CMS based upon a regular reassessment of the readiness of its electronic trading partners. In response, WebMD Business Services announced a contingency plan, pursuant to which it continues to process HIPAA standard transactions and, for a limited period of time, will also process legacy transactions as appropriate based on applicable law and the needs of our business partners.

On February 27, 2004, CMS modified its Medicare contingency plan to delay the payment of electronic claims that are not HIPAA-compliant. Specifically, effective July 1, 2004, only claims that are compliant with the Transaction Standards are reported as electronic media claims (EMC), which may be paid no earlier than after a 13-day waiting period. All other claims (including both electronic claims that are not compliant with the Transaction Standards, as well as paper claims) may be paid no earlier than after a 26-day waiting period. Calling it a "measured step toward ending the contingency plan entirely," CMS implemented the change to encourage providers to move more quickly with their efforts to achieve HIPAA compliance. This policy may provide an incentive for providers who cannot send HIPAA standard claims from their desktop to use a clearinghouse, such as WebMD Business Services, to do so.

CMS has made clear that it expects each party to every transaction to be accountable for compliance with the new standards. However, the CMS Guidance provides for a flexible, complaint-driven enforcement strategy that will take into consideration good faith efforts to comply with the Transaction Standards. We believe that CMS's enforcement approach assisted in reducing disruptions in the flow of electronic transactions that otherwise could have occurred. We cannot provide assurance regarding how CMS will regulate clearinghouses in general or WebMD Business Services in particular. In addition, even though major disruptions in the flow of electronic transactions may be less likely in light of CMS's current approach to enforcement of the Transaction Standards, we have experienced isolated disruptions and some delays and we expect that there will continue to be some problems for a period of time. We continue to work diligently to identify and resolve problems as they occur. The costs to us of dealing with those problems are inherently difficult to estimate and may be more than we expect and/or continue for longer than anticipated. In addition, most of our trading partners are currently operating under their own contingency plans and, accordingly, we would expect that there will be further disruptions during the adjustment period that occurs once CMS requires all applicable parties to perform in accordance with the Transaction Standards. We may not have enough technicians, programmers and customer service personnel



**Table of Contents**

to meet the demands placed on those functions by our customers and partners during that adjustment period, which could adversely affect our relationships with them.

*Implementation Challenges.* Implementation of the Transaction Standards has presented us with significant technical and operational challenges. For example, the Transaction Standards cover not only transaction formats, but also required content, including some content not previously collected by most providers. We are working with our trading partners on quality assurance and testing as we enhance our clearinghouse services for transmitting additional data content provided for in the Transaction Standards. We plan to place these services into production as both our systems and payers' adjudication systems become fully capable of handling the additional data content. As with any highly complex transition involving significant modifications to trading partner systems, we have experienced some problems during this process. Another aspect of the implementation challenges resulting from the Transaction Standards is the increase in computing capacity required. The Transaction Standards formats are much larger than the pre-existing ones. We are utilizing more computing capacity than we had anticipated. As a result, our systems have experienced inefficiencies that have resulted in processing delays. We seek to resolve all such problems when identified, but testing continues with numerous submitters and payers and no assurance can be given that we will identify all problems promptly or that we will not continue to experience problems that delay the full implementation of these enhanced data services. See also During times when we are making significant changes to our products and services, there are increased risks of performance problems above.

From October 16, 2003 to the date of this Quarterly Report, a large majority of the claims we have received from submitters used legacy formats and very few contained the additional data content provided for in the Transaction Standards. A small number of our submitters currently send some additional HIPAA data content that does not yet pass through our clearinghouse. In order to facilitate transmission of claims with the standard HIPAA format, our clearinghouse software uses edits, including the use of default data, in the transmission of claims from our clearinghouse and some data received by us is not transmitted by us. To date, our software, editing procedures and production criteria for additional HIPAA content have not had a material effect on our ability to process and transmit transactions.

*Implementation Costs.* We have been incurring, and may continue to incur, significant expenses relating to implementation of the Transaction Standards. Implementation of the Transaction Standards has required us, among other things, to make significant changes to the software WebMD Business Services uses internally, to engage in testing with its customers and to implement additional quality assurance processes. If our reprogramming and testing are not completed on a timely basis, we could lose customers and revenues. In addition, our ability to perform our transaction services in compliance with HIPAA and the cost to us of doing so will depend on, among other things, the status of the compliance efforts of our payer and provider customers and the extent of the need to adjust our systems and procedures in response to changes in their systems and procedures. We cannot control when or how payers, providers, practice management system vendors or other healthcare participants will comply with the Transaction Standards or predict how their compliance efforts will affect their relationships with us, including the volume of transactions for which they use our services. Our technological and strategic responses to the Transaction Standards may result in conflicts with, or other adverse changes in our relationships with, some healthcare industry participants, including some who are existing or potential customers for our products and services or existing or potential strategic partners.

*Use of Direct Links.* Although the standardization of formats and data standards required by HIPAA is only partial and we believe that use of clearinghouses will continue to be the most efficient way for most providers to transact electronically with multiple payers, such standardization may facilitate use of direct EDI links for transmission of transactions between a greater number of healthcare payers and providers without use of a clearinghouse. Any significant increase in the utilization of direct links between healthcare providers and payers could have a material adverse effect on WebMD Business Services' transaction volume and financial results. See also The financial results of WebMD Business Services could be adversely affected if payers conduct electronic data interchange, or EDI, transactions without using a

**Table of Contents**

clearinghouse or if their ability to do so allows them to terminate or modify their relationships with us above.

For additional information regarding the Transaction Standards and a discussion of the risks and challenges associated with other portions of HIPAA and related regulations, see Business Government Regulation in our 2003 Annual Report on Form 10-K.

*Other regulations under HIPAA create risks and challenges with respect to our compliance efforts, business strategies and customer relationships*

*Risks Relating to the HIPAA Privacy Standards.* The HIPAA Standards for Privacy of Individually Identifiable Health Information, which we refer to as the Privacy Standards, establish a set of basic national privacy standards and fair information practices for the protection by health plans, healthcare clearinghouses, healthcare providers and their business associates of individually identifiable health information. This rule became effective on April 14, 2001 and the compliance date for most entities was April 14, 2003. The Privacy Standards apply to the portions of our business that process healthcare transactions or provide certain technical services to other participants in the healthcare industry, and certain of our portal services may be affected through contractual relationships. This rule provides for civil and criminal liability for its breach and requires us, our customers and our partners to use health information in a highly restricted manner, to establish policies and procedures to safeguard the information, to obtain individual authorizations for some activities, and to provide certain access rights to individuals. This rule may restrict the manner in which we transmit and use certain information. There can be no assurances that we will adequately address the risks created by the Privacy Standards or that we will be able to take advantage of any resulting opportunities. In addition, we are unable to predict what changes to the Privacy Standards might be made in the future or how those changes could affect our business.

*Risks Relating to the HIPAA Unique Employer Identifier Standard.* The HIPAA Unique Employer Identifier Standard establishes a standard for identifying employers in healthcare transactions where information about the employer is transmitted electronically, as well as requirements concerning its use by covered entities. This rule requires the use of an employer identification number (EIN) as assigned by the IRS on all standard transactions that require an employer identifier to identify a person or entity as an employer. This standard applies to the portions of our business that process healthcare transactions or provide certain technical services to other participants in the healthcare industry, and certain of our portal services may be affected through contractual relationships. Most participants in the healthcare industry were required to be in compliance with the Unique Employer Identifier Standard by July 30, 2004. The effect of the Unique Employer Identifier Standard on our business is difficult to predict and there can be no assurances that we will adequately address the risks created by the Unique Employer Identifier Standard and its implementation or that we will be able to take advantage of any resulting opportunities.

*Risks Relating to the HIPAA Security Standards.* On February 20, 2003, HHS published the final HIPAA Security Standards. The Security Standards establish detailed requirements for safeguarding patient information that is electronically transmitted or electronically stored. The rule establishes 42 implementation specifications, 20 of which are required, meaning they must be implemented as specified in the rule. Twenty-two are addressable. Complying with addressable implementation specifications requires a business to assess whether they constitute a reasonable and appropriate safeguard for the particular business; if not, an alternative approach must be designed and implemented to achieve the particular standard. The Security Standards apply to the portions of our business that process healthcare transactions, that provide certain technical services to other participants in the healthcare industry, or that enable electronic communications of patient information among healthcare industry participants, and certain of our portal services may be affected through contractual relationships. Most participants in the healthcare industry must be in compliance with the Security Standards by April 21, 2005. Some of the Security Standards are technical in nature, while others may be addressed through policies and procedures for using information systems. The Security Standards may require us to incur significant costs in evaluating our products and in establishing that our systems meet the legal requirements. We are unable to

**Table of Contents**

predict what changes might be made to the Security Standards prior to the 2005 implementation deadline or how those changes might help or hinder our business. The effect of the Security Standards on our business is difficult to predict and there can be no assurances that we will adequately address the risks created by the Security Standards and their implementation or that we will be able to take advantage of any resulting opportunities.

*Risks Relating to the HIPAA NPI Standard.* On January 23, 2004, HHS published the final HIPAA standard for a unique health identifier for health care providers, commonly referred to as the National Provider Identifier Standard, or the NPI Standard. The NPI Standard requires health care providers that transmit any health information in electronic form in connection with a HIPAA covered transaction to obtain a single, 10 position all-numeric NPI from the National Provider System (NPS), and to use the NPI in standard transactions where a provider identifier is required. The NPI Standard requires health plans and health care clearinghouses to use a provider's NPI to identify the provider on all standard transactions where that provider's identifier is required. The NPI Standard is effective May 23, 2005. Most participants in the healthcare industry must be in compliance with the NPI Standard by May 23, 2007. There can be no assurances that we will adequately address any business risks created by the NPI rule and its implementation or that we will be able to take advantage of any resulting business opportunities.

*Changes in government regulation or industry guidelines could adversely affect our continuing medical education offerings*

WebMD Health's Medscape physician portal is a leading provider of online continuing medical education, or CME, to physicians and other healthcare professionals, offering a wide selection of free, regularly updated online CME activities. We receive funding from pharmaceutical and medical device companies for these CME programs. See Business Healthcare Information Services and Technology Solutions WebMD Health *Medscape from WebMD* Continuing Medical Education (CME) in our 2003 Annual Report on Form 10-K.

Our CME activities are planned and implemented in accordance with the Essential Areas and Policies of the Accreditation Council for Continuing Medical Education, or ACCME, which oversees providers of CME credit, and other applicable accreditation standards. In addition, some of our programs have been produced in collaboration with other ACCME-accredited CME providers. Medscape received provisional ACCME accreditation as a CME provider in July 2002 and full accreditation, for a four-year period, beginning in July 2004. Such accreditation allows Medscape to continue to certify online CME activities. In September 2004, ACCME revised its standards for commercial support of CME. The revised standards are intended to ensure that CME activities of ACCME-accredited providers are independent of providers of healthcare goods and services that fund the development of CME. ACCME expects accredited providers to implement these standards by May 2005. Implementation has required additional disclosures to CME participants about those in a position to influence content and other adjustments to the management and operations of our CME programs. Medscape believes it has modified its procedures as appropriate to meet the revised standards. However, we cannot be certain whether these adjustments will ensure that we meet the new standards or predict whether ACCME may impose additional requirements.

Provision of CME may also be subject to government regulation by the Food and Drug Administration, or FDA, and the Office of Inspector General, or OIG, of the United States Department of Health and Human Services, a federal agency responsible for interpreting certain federal laws relating to healthcare. Among the goals of regulation of CME are ensuring that funding of CME programs by pharmaceutical and medical device companies is not a means for them to

improperly promote their products,

provide improper remuneration to physicians or others in a position to generate business for the sponsoring companies, or

improperly influence or control the content of CME programs.

**Table of Contents**

See Business Government Regulation Regulation of Healthcare Relationships and FDA and FTC Regulation of Drug and Medical Device Advertising and Promotion in our 2003 Annual Report on Form 10-K and Other government regulation of healthcare and healthcare information technology creates risks and challenges with respect to our compliance efforts and our business strategies below.

Increased regulatory scrutiny of CME sponsorship by pharmaceutical or medical device companies, changes to existing regulations or accreditation standards, or changes in internal compliance procedures of potential sponsors may require Medscape to make changes in the way it offers or provides CME programs, may slow sponsors' internal approval processes for CME, and may reduce the volume of sponsored CME programs implemented by Medscape to levels that are lower than expected.

*Other government regulation of healthcare and healthcare information technology creates risks and challenges with respect to our compliance efforts and our business strategies*

*General.* The healthcare industry is highly regulated and is subject to changing political, regulatory and other influences. These factors affect the purchasing practices and operations of healthcare organizations. Federal and state legislatures and agencies periodically consider programs to reform or revise the United States healthcare system. These programs may contain proposals to increase governmental involvement in healthcare, lower reimbursement rates or otherwise change the environment in which healthcare industry participants operate. Healthcare industry participants may respond by reducing their investments or postponing investment decisions, including investments in our applications and services. We are unable to predict future proposals with any certainty or to predict the effect they would have on our business. In addition, existing laws and regulations could create liability, cause us to incur additional costs or restrict our operations. Although we carefully review our practices with regulatory experts in an effort to ensure that we are in compliance with all applicable state and federal laws, these laws are complex and subject to interpretation by courts and other governmental authorities, who may take positions that are inconsistent with our practices.

*Healthcare Relationships.* A federal law commonly known as the Federal Healthcare Programs anti-kickback law and several similar state laws prohibit payments that are intended to induce healthcare providers either to refer patients or to acquire or arrange for or recommend the acquisition of healthcare products or services. These laws are broad and may apply to some of our activities or our relationships with our customers, advertisers or strategic partners. Other federal and state laws generally prohibit individuals or entities from knowingly presenting, or causing to be presented, claims for payment from Medicare, Medicaid, or other third-party payers that are false or fraudulent, or are for items or services that were not provided as claimed. Since we provide transaction services to healthcare providers, we cannot provide assurance that the government will regard errors in transactions processed by us as inadvertent and not in violation of these laws. In addition, our transaction services include providing edits, using logic, mapping and defaults, to enhance the information submitted in claims in order to assist in claims processing. We believe that our editing practices are in compliance with industry practice; however, it is possible that a court or governmental agency might interpret these laws in a different manner, which could result in liability and adversely affect our business. In addition, changes in these laws could also require us to incur costs or restrict our business operations. Many anti-kickback and false claims laws prescribe civil and criminal penalties for noncompliance that can be substantial. Even an unsuccessful challenge by regulatory authorities of our practices could cause us adverse publicity and be costly for us to respond to.

*Regulation of Medical Devices.* Certain of Porex's products are medical devices regulated by the Food and Drug Administration, or FDA, such as plastic and reconstructive surgical implants. These products are subject to comprehensive FDA regulation under the Food, Drug and Cosmetic Act and implementing regulations. In addition, the FDA regulates WebMD Practice Services' DIM<sub>x</sub>® System as a medical image management device. If the FDA were to find that we have not complied with regulatory requirements, it can bring a wide variety of enforcement actions that could result in severe civil and criminal sanctions. Porex is also subject to similar regulation in international markets, with similar risks. Future products that we wish to bring to market may require clearances or approvals from governmental

**Table of Contents**

authorities, which may be expensive, time-consuming and burdensome to obtain or which may never be obtained.

For more information regarding healthcare regulation to which we are or may be subject, see **Business Government Regulation** in our 2003 Annual Report on Form 10-K.

---

**Risks Related to Our Web Sites and Our Use of the Internet**

*Government regulation of the Internet could adversely affect our business*

The Internet and its associated technologies are subject to government regulation. Our failure, or the failure of our business partners, to accurately anticipate the application of applicable laws and regulations, or any other failure to comply, could create liability for us, result in adverse publicity, or negatively affect our business. In addition, new laws and regulations, or new interpretations of existing laws and regulations, may be adopted with respect to the Internet or other online services covering user privacy, patient confidentiality, consumer protection and other issues, including pricing, content, copyrights and patents, distribution, and characteristics and quality of products and services. We cannot predict whether these laws or regulations will change or how such changes will affect our business. Government regulation of the Internet could limit the effectiveness of the Internet for services that we are providing or developing or even prohibit particular services.

For more information regarding government regulation of the Internet to which we are or may be subject, see **Business Government Regulation** in our 2003 Annual Report on Form 10-K.

*We face potential liability related to the privacy and security of personal information we collect on our Web sites*

Internet user privacy has become a controversial issue both in the United States and abroad. We have privacy policies posted on our consumer portals and our professional portal that we believe comply with applicable laws requiring notice to users about our information collection, use and disclosure practices. However, whether and how existing privacy and consumer protection laws in various jurisdictions apply to the Internet is still uncertain and may take years to resolve. Any legislation or regulation in the area of privacy of personal information could affect the way we operate our Web sites and could harm our business. Further, we can give no assurance that the statements on our portals, or our practices, will be found sufficient to protect us from liability or adverse publicity in this area.

Some of our portal services may, through contractual relationships, be affected by the HIPAA Privacy Standards and Security Standards. For more information regarding the HIPAA Privacy and Security Standards and other regulation of the collection, use and disclosure of personal information to which we may be subject, see **Business Government Regulation** in our 2003 Annual Report on Form 10-K.

*Our ability to maintain or increase our Portal Services sponsorship revenues will depend, in part, on our ability to retain or increase usage of our Portal Services by consumers and physicians*

WebMD Health generates revenues by, among other things, selling sponsorships of specific pages, sections or events on its online physician and consumer portals and related e-mailed newsletters. Our WebMD Health sponsors include pharmaceutical, biotech, medical device and consumer products companies that are interested in communicating with and educating our audience or parts of our audience. While we currently attract a large audience of health-involved consumers and clinically active healthcare professionals to our online offerings, we cannot provide assurance that we will continue to do so. Users of our portals have numerous other online and offline sources of healthcare information services. In addition, some of WebMD Health's traffic and new members come to it through relationships with third parties, including MSN and AOL, and, as a result, may vary based on the amount of traffic to sites of the third parties and other factors outside our control. We expect that our relationship with MSN will not continue after the end of 2004.

**Table of Contents**

*Implementation of changes in hardware and software platforms used to deliver our Web sites may result in performance problems*

From time to time, we implement changes to the hardware and software platforms we use for creating and delivering our Web sites. During and after the implementation of those changes, a platform may not perform as expected, which could result in interruptions in the operation of our Web sites, an increase in response time of those sites or an inability to track performance metrics.

Any significant interruption in our ability to operate our Web sites could have an adverse effect on our relationship with users and sponsors and, as a result, on our financial results.

*Our Internet-based services require uninterrupted communications and computer service from third-party service providers and our own systems*

Our Web sites are designed to operate 24 hours a day, seven days a week, without interruption. To do so, we rely on communications and hosting services provided by third parties. We also rely on internal systems to prepare and deliver content for our Web sites and for other purposes. We do not maintain redundant systems or facilities for some of these services. To operate without interruption, both we and our service providers must guard against:

damage from fire, power loss and other natural disasters;

communications failures;

software and hardware errors, failures or crashes;

security breaches, computer viruses and similar disruptive problems; and

other potential interruptions.

We have experienced periodic system interruptions in the past, and we cannot guarantee that they will not occur again. In addition, our Web sites may, at times, be required to accommodate higher than usual volumes of traffic. At those times, our Web sites may experience slower response times or system failures. Any sustained or repeated interruptions or disruptions in these systems or increase in their response times could result in reduced usage of our Web sites and could damage our relationships with strategic partners, advertisers and sponsors. Although we maintain insurance for our business, we cannot guarantee that our insurance will be adequate to compensate us for all losses that may occur or to provide for costs associated with business interruptions.

*Our Internet-based services are dependent on the development and maintenance of the Internet infrastructure*

Our ability to deliver our Internet-based services is dependent on the development and maintenance of the infrastructure of the Internet by third parties. This includes maintenance of a reliable network backbone with the necessary speed, data capacity and security, as well as timely development of complementary products such as high-speed modems, for providing reliable Internet access and services. The Internet has experienced, and is likely to continue to experience, significant growth in the number of users and the amount of traffic. If the Internet continues to experience increased usage, the Internet infrastructure may be unable to support the demands placed on it. In addition, the performance of the Internet may be harmed by increased usage.

The Internet has experienced a variety of outages and other delays as a result of damages to portions of its infrastructure, and it could face outages and delays in the future. These outages and delays could reduce the level of Internet usage as well as the availability of the Internet to us for delivery of our Internet-based services. In addition, our customers who utilize our Web-based services depend on Internet service providers, online service providers and other Web site operators for access to our Web site. All of these providers have experienced significant outages in the past and could experience outages, delays and other difficulties in the future due to system failures unrelated to our systems. Any significant interruptions

## **Table of Contents**

in our services or increases in response time could result in a loss of potential or existing users of and advertisers and sponsors on our Web site and, if sustained or repeated, could reduce the attractiveness of our services.

### *Third parties may challenge the enforceability of our online agreements*

The law governing the validity and enforceability of online agreements and other electronic transactions is evolving. We could be subject to claims by third parties that our online agreements with consumers and physicians that provide the terms and conditions for use of our portal services are unenforceable. A finding by a court that these agreements are invalid could harm our business and require costly changes to our portals.

### *Third parties may bring claims against us as a result of content provided on our Web sites, which may be expensive and time consuming to defend*

We could be subject to third-party claims based on the nature and content of information supplied on our Web sites by us or third parties, including content providers, medical advisors or users. We could also be subject to liability for content that may be accessible through our Web sites or third-party Web sites linked from our Web sites or through content and information that may be posted by users in chat rooms, bulletin boards or on Web sites created by professionals using our Web site application. Even if these claims do not result in liability to us, investigating and defending against these claims could be expensive and time consuming and could divert management's attention away from our operations.

---

## **Risks Related to Porex's Business and Industry**

### *Porex's success depends upon demand for its products, which in some cases ultimately depends upon end-user demand for the products of its customers*

Demand for our Porex products may change materially as a result of economic or market conditions and other trends that affect the industries in which Porex participates. In addition, because a significant portion of our Porex products are components that are eventually integrated into or used with products manufactured by customers for resale to end-users, the demand for these product components is dependent on product development cycles and marketing efforts of these other manufacturers, as well as variations in their inventory levels, which are factors that we are unable to control. Accordingly, the amount of Porex's sales to manufacturer customers can be difficult to predict and subject to wide quarter-to-quarter variances.

### *Porex's success may depend on satisfying rapidly changing customer requirements*

A significant portion of our Porex products are integrated into end products used in various industries, some of which are characterized by rapidly changing technology, evolving industry standards and practices and frequent new product introductions. Accordingly, Porex's success depends to a substantial degree on our ability to develop and introduce in a timely manner products that meet changing customer requirements and to differentiate our offerings from those of our competitors. If we do not introduce new Porex products in a timely manner and make enhancements to existing products to meet the changing needs of our Porex customers, some of our products could become obsolete over time, in which case our customer relationships, revenue and operating results would be negatively impacted.

### *Potential new or enhanced Porex products may not achieve sufficient sales to be profitable or justify the cost of their development*

We cannot be certain, when we engage in Porex research and development activities, whether potential new products or product enhancements will be accepted by the customers for which they are intended. Achieving market acceptance for new or enhanced products may require substantial marketing efforts and expenditure of significant funds to create awareness and demand by potential customers. In

## **Table of Contents**

addition, sales and marketing efforts with respect to these products may require the use of additional resources for training our existing Porex sales forces and customer service personnel and for hiring and training additional salespersons and customer service personnel. There can be no assurance that the revenue opportunities from new or enhanced products will justify amounts spent for their development and marketing. In addition, there can be no assurance that any pricing strategy that we implement for any new or enhanced Porex products will be economically viable or acceptable to the target markets.

### *Porex may not be able to source the raw materials it needs or may have to pay more for those raw materials*

Some of Porex's products require high-grade plastic resins with specific properties as raw materials. While Porex has not experienced any material difficulty in obtaining adequate supplies of high-grade plastic resins that meet its requirements, it relies on a limited number of sources for some of these plastic resins. If Porex experiences a reduction or interruption in supply from these sources, it may not be able to access alternative sources of supply within a reasonable period of time or at commercially reasonable rates, which could have a material adverse effect on its business and financial results.

### *Disruptions in Porex's manufacturing operations could have a material adverse effect on its business and financial results*

Any significant disruption in Porex's manufacturing operations, including as a result of fire, power interruptions, equipment malfunctions, labor disputes, material shortages, earthquakes, floods, computer viruses, sabotage, terrorist acts or other force majeure, could have a material adverse effect on Porex's ability to deliver products to customers and, accordingly, its financial results.

### *The nature of Porex's products exposes it to product liability claims that may not be adequately covered by indemnity agreements or insurance*

The products sold by Porex, whether sold directly to end-users or sold to other manufacturers for inclusion in the products that they sell, expose it to potential risk of product liability claims, particularly with respect to Porex's life sciences, clinical, surgical and medical products. Some of Porex's products are designed to be permanently implanted in the human body. Design defects and manufacturing defects with respect to such products sold by Porex or failures that occur with the products of Porex's manufacturer customers that contain components made by Porex could result in product liability claims and/or a recall of one or more of Porex's products. Porex believes that it carries adequate insurance coverage against product liability claims and other risks. We cannot assure you, however, that claims in excess of Porex's insurance coverage will not arise. In addition, Porex's insurance policies must be renewed annually. Although Porex has been able to obtain adequate insurance coverage at an acceptable cost in the past, we cannot assure you that Porex will continue to be able to obtain adequate insurance coverage at an acceptable cost.

In most instances, Porex enters into indemnity agreements with its manufacturing customers. These indemnity agreements generally provide that these customers would indemnify Porex from liabilities that may arise from the sale of their products that incorporate Porex components to, or the use of such products by, end-users. While Porex generally seeks contractual indemnification from its customers, any such indemnification is limited, as a practical matter, to the creditworthiness of the indemnifying party. If Porex does not have adequate contractual indemnification available, product liability claims, to the extent not covered by insurance, could have a material adverse effect on its business, operating results and financial condition.

Since March 1991, Porex has been named as one of many co-defendants in a number of actions brought by recipients of mammary implants distributed by Porex in the United States. For a description of these actions, see the information under "Legal Proceedings - Porex Mammary Implant Litigation" in our 2003 Annual Report on Form 10-K.



**Table of Contents**

*Economic, political and other risks associated with Porex's international sales and geographically diverse operations could adversely affect Porex's operations and results*

Since Porex sells its products worldwide, its business is subject to risks associated with doing business internationally. In addition, Porex has manufacturing facilities in the United Kingdom, Germany and Malaysia. Accordingly, Porex's operations and financial results could be harmed by a variety of factors, including:

changes in foreign currency exchange rates;

changes in a specific country's or region's political or economic conditions, particularly in emerging markets;

trade protection measures and import or export licensing requirements;

potentially negative consequences from changes in tax laws;

difficulties in managing international and geographically diverse operations;

differing protection of intellectual property; and

unexpected changes in regulatory requirements.

*Environmental regulation could adversely affect Porex's business*

Porex is subject to foreign and domestic environmental laws and regulations and is subject to scheduled and random checks by environmental authorities. Porex's business involves the handling, storage and disposal of materials that are classified as hazardous. Although Porex's safety procedures for handling, storage and disposal of these materials are designed to comply with the standards prescribed by applicable laws and regulations, Porex may be held liable for any environmental damages that result from Porex's operations. Porex may be required to pay fines, remediation costs and damages, which could have a material adverse effect on its results of operations.

---

**Risks Applicable to Our Entire Company**

*The ongoing investigations by the United States Attorney for the District of South Carolina and the SEC could negatively impact our company and divert management attention from our business operations*

The United States Attorney for the District of South Carolina is conducting an investigation of our company. Based on the information available to WebMD as of the date of this Quarterly Report, we believe that the investigation relates principally to issues of financial accounting improprieties for Medical Manager Corporation, a predecessor of WebMD (by its merger into WebMD in September 2000), and our Medical Manager Health Systems subsidiary; however, we cannot be sure of the investigation's exact scope or how long it may continue. In addition, WebMD understands that the SEC is conducting a formal investigation into this matter. Adverse developments in connection with the investigations, if any, including as a result of matters that the authorities or WebMD may discover, could have a negative impact on our company and on how it is perceived by investors and potential investors and customers and potential customers. In addition, the management effort and attention required to respond to the investigations and any such developments could have a negative impact on our business operations. For additional information, see "Legal Proceedings" in Part II, Item 1 of this Quarterly Report.

WebMD intends to continue to fully cooperate with the authorities in this matter. While we are not able to estimate, at this time, the amount of the expenses that we will incur in connection with the investigations, we expect that they may continue to be significant.

**Table of Contents**

*We face significant competition for our products and services*

The markets in which we operate are intensely competitive, continually evolving and, in some cases, subject to rapid technological change. Many of our competitors have greater financial, technical, product development, marketing and other resources than we do. These organizations may be better known than we are and have more customers than we do. We cannot provide assurance that we will be able to compete successfully against these organizations or any alliances they have formed or may form. For more information about the competition we face, see Business Healthcare Information Services and Technology Solutions Competition for Our Healthcare Information Services and Technology Solutions and Business Porex Competition in our 2003 Annual Report on Form 10-K.

*The performance of our businesses depends on attracting and retaining qualified executives and employees*

Our performance depends on attracting and retaining key personnel, including executives, product managers, software developers and other technical personnel and sales and marketing personnel. Failure to do so could have a material adverse effect on the performance of our business and the results of our operations.

*We may not be successful in protecting our intellectual property and proprietary rights*

Our intellectual property is important to all of our businesses. We rely on a combination of trade secret, patent and other intellectual property laws and confidentiality procedures and non-disclosure contractual provisions to protect our intellectual property. We believe that our non-patented proprietary technologies and business and manufacturing processes are protected under trade secret, contractual and other intellectual property rights. However, those rights do not afford the statutory exclusivity provided by patented processes. In addition, the steps that we take to protect our intellectual property, proprietary information and trade secrets may prove to be inadequate and, whether or not adequate, may be expensive.

There can be no assurance that we will be able to detect potential or actual misappropriation or infringement of our intellectual property, proprietary information or trade secrets. Even if we detect misappropriation or infringement by a third party, there can be no assurance that we will be able to enforce our rights at a reasonable cost, or at all. In addition, our rights to intellectual property, proprietary information and trade secrets may not prevent independent third-party development and commercialization of competing products or services.

*Third parties may claim that we are infringing their intellectual property, and we could suffer significant litigation or licensing expenses or be prevented from selling products or services*

We could be subject to claims that we are misappropriating or infringing intellectual property or other proprietary rights of others. These claims, even if not meritorious, could be expensive to defend and divert management's attention from our operations. If we become liable to third parties for infringing these rights, we could be required to pay a substantial damage award and to develop non-infringing technology, obtain a license or cease selling the products or services that use or contain the infringing intellectual property. We may be unable to develop non-infringing products or services or obtain a license on commercially reasonable terms, or at all. We may also be required to indemnify our customers if they become subject to third-party claims relating to intellectual property that we license or otherwise provide to them, which could be costly.

*We have incurred and may continue to incur losses*

We began operations in January 1996 and have incurred net losses in each year since our inception and, as of September 30, 2004, we had an accumulated deficit of approximately \$10.2 billion. Although we generated net income, determined in accordance with U.S. generally accepted accounting principles, during certain quarterly periods, including the quarterly period ended September 30, 2004, we incurred a net loss for the year ended December 31, 2003. We currently intend to continue to invest in infrastructure

**Table of Contents**

development, applications development, sales and marketing, and acquisitions and whether we continue to incur losses in a particular period will depend on, among other things, the amount of such investments and whether those investments lead to increased revenues.

*We may be subject to litigation*

Our business and operations may subject us to claims, litigation and other proceedings brought by private parties and governmental authorities. For information regarding certain proceedings to which we are currently a party, see *Legal Proceedings* in our 2003 Annual Report on Form 10-K and Part II, Item 1 of this Quarterly Report.

*Business combinations and other transactions may be difficult to complete and, if completed, may have negative consequences for our business and our securityholders*

We intend to seek to acquire or to engage in business combinations with companies engaged in complementary businesses. In addition, we may enter into joint ventures, strategic alliances or similar arrangements with third parties. These transactions may result in changes in the nature and scope of our operations and changes in our financial condition. Our success in completing these types of transactions will depend on, among other things, our ability to locate suitable candidates and negotiate mutually acceptable terms with them, as well as the availability of financing. Significant competition for these opportunities exists, which may increase the cost of and decrease the opportunities for these types of transactions. Financing for these transactions may come from several sources, including:

cash and cash equivalents on hand and marketable securities,

proceeds from the incurrence of indebtedness, and

proceeds from the issuance of additional common stock, preferred stock, convertible debt or other securities.

Our issuance of additional securities could:

cause substantial dilution of the percentage ownership of our stockholders at the time of the issuance,

cause substantial dilution of our earnings per share, and

adversely affect the prevailing market price for our outstanding securities.

We do not intend to seek securityholder approval for any such acquisition or security issuance unless required by applicable law or regulation or the terms of existing securities.

*Our business will suffer if we fail to successfully integrate acquired businesses and technologies or to assess the risks in particular transactions*

We have in the past acquired, and may in the future acquire, businesses, technologies, services, product lines and other assets. The successful integration of the acquired businesses and assets into our operations, on a cost-effective basis, can be critical to our future performance. The amount and timing of the expected benefits of any acquisition, including potential synergies between WebMD and the acquired business, are subject to significant risks and uncertainties. These risks and uncertainties include, but are not limited to, those relating to:

our ability to maintain relationships with the customers of the acquired business;

our ability to cross-sell products and services to customers with which we have established relationships and those with which the acquired businesses have established relationships;

our ability to retain or replace key personnel;

potential conflicts in payer, provider, strategic partner, sponsor or advertising relationships;

**Table of Contents**

our ability to coordinate organizations that are geographically diverse and may have different business cultures; and  
compliance with regulatory requirements.

We cannot guarantee that any acquired businesses will be successfully integrated with our operations in a timely or cost-effective manner, or at all. Failure to successfully integrate acquired businesses or to achieve anticipated operating synergies, revenue enhancements or cost savings could have a material adverse effect on our business, financial condition and results of operations.

Although our management attempts to evaluate the risks inherent in each transaction and to value acquisition candidates appropriately, we cannot assure you that we will properly ascertain all such risks or that acquired businesses and assets will perform as we expect or enhance the value of our company as a whole. In addition, acquired companies or businesses may have larger than expected liabilities that are not covered by the indemnification, if any, we are able to obtain from the sellers.

*We may not be able to raise additional funds when needed for our business or to exploit opportunities*

Our future liquidity and capital requirements will depend upon numerous factors, including the success of the integration of our businesses, our existing and new applications and service offerings, competing technologies and market developments, potential future acquisitions and additional repurchases of our common stock. We may need to raise additional funds to support expansion, develop new or enhanced applications and services, respond to competitive pressures, acquire complementary businesses or technologies or take advantage of unanticipated opportunities. If required, we may raise such additional funds through public or private debt or equity financing, strategic relationships or other arrangements. There can be no assurance that such financing will be available on acceptable terms, if at all, or that such financing will not be dilutive to our stockholders.

**Table of Contents**

**ITEM 3. *Quantitative and Qualitative Disclosures About Market Risk***  
**Interest Rate Sensitivity**

The primary objective of our investment activities is to preserve principal and maintain adequate liquidity, while at the same time maximizing the yield we receive from our investment portfolio. This objective is accomplished by adherence to our investment policy, which establishes the list of eligible securities and credit requirements for each investment.

Changes in prevailing interest rates will cause the principal amount of the investment to fluctuate. To minimize this risk, we maintain our portfolio of cash equivalents, short-term investments and marketable securities in commercial paper, non-government debt securities, money market funds and highly liquid U.S. Treasury Notes. We view these high grade securities within our portfolio as having similar market risk characteristics.

Principal amounts expected to mature are \$0.2 million, \$55.6 million, \$398.7 million and \$85.0 million during the remainder of 2004, 2005, 2006 and 2007, respectively. These include investments totaling \$452.6 million in Federal Agency Notes that are callable, subjecting us to interest rate risk on the reinvestment of these securities. We believe that the impact of any call and resulting reinvestment of proceeds would not have a material effect on our financial condition or results of operations.

We have not utilized derivative financial instruments in our investment portfolio.

**Exchange Rate Sensitivity**

Currently, substantially all of our sales and expenses are denominated in United States dollars; however, Porex is exposed to fluctuations in foreign currency exchange rates, primarily the rate of exchange of the United States dollar against the Euro. This exposure arises primarily as a result of translating the results of Porex's foreign operations to the United States dollar at exchange rates that have fluctuated from the beginning of the accounting period. Porex has not engaged in foreign currency hedging activities to date. Foreign currency translation gains (losses) were \$0.2 million and \$(0.1) million, during the three and nine month periods ended September 30, 2004, and \$0.1 million and \$1.6 million, during the three and nine month periods ended September 30, 2003.

**ITEM 4. *Controls and Procedures***

As required by Exchange Act Rule 13a-15(b), WebMD management, including the Chief Executive Officer and Chief Financial Officer, conducted an evaluation of the effectiveness of WebMD's disclosure controls and procedures, as defined in Exchange Act Rule 13a-15(e), as of September 30, 2004. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that WebMD's disclosure controls and procedures provided reasonable assurance that all material information required to be filed in this Quarterly Report has been made known to them in a timely fashion.

In connection with the evaluation required by Exchange Act Rule 13a-15(d), WebMD management, including the Chief Executive Officer and Chief Financial Officer, concluded that no changes in WebMD's internal control over financial reporting occurred during the third quarter of 2004 that have materially affected, or are reasonably likely to materially affect, WebMD's internal control over financial reporting.

**Table of Contents**

**PART II**

**OTHER INFORMATION**

**ITEM 1. *Legal Proceedings***

**Merrill Lynch Fundamental Growth Fund, Inc. et al. v. McKesson HBOC, Inc., et al.**

As more fully described in Part I, Item 3 of our 2003 Annual Report on Form 10-K (and as previously updated in Part II, Item 1 of our Quarterly Reports on Form 10-Q for the quarters ended March 31, 2004 and June 30, 2004), WebMD was named as a defendant in the action *Merrill Lynch Fundamental Growth Fund, Inc., et al. v. McKesson HBOC, Inc., et al.*, Case No. 405792, in the San Francisco Superior Court (which we refer to as the California Action). The original complaint in this matter alleged that McKesson HBOC (now known as McKesson Corp.), HBO and Company (which we refer to as HBOC), certain officers and directors of those firms, Arthur Andersen LLP, and Bear Stearns & Co. engaged in a number of practices whereby HBOC and later McKesson HBOC improperly recognized revenues. On September 4, 2003, the plaintiffs filed a fourth amended complaint, naming WebMD and two other defendants, General Electric Capital Corporation, Inc. and Computer Associates International, Inc., for the first time. The complaint alleges that WebMD aided and abetted alleged fraud by certain defendants and conspired with those defendants in relation to HBOC's and McKesson HBOC's alleged improper recognition of approximately \$14 million in revenue on two software transactions. The plaintiffs also allege that WebMD made certain negligent misrepresentations with respect to these transactions. On December 16, 2003, WebMD filed a demurrer, seeking dismissal of plaintiffs' two claims against it.

In March 2004, McKesson Corp. filed cross-complaints against General Electric Capital Corporation, Inc., Computer Associates International, Inc., and WebMD for declaratory relief and indemnification, alleging that each of these cross-defendants is obligated to indemnify McKesson if McKesson is compelled to pay any sum as the result of any damages, judgment or other awards recovered by the plaintiffs against McKesson. McKesson seeks judicial determinations of the comparative fault of McKesson and each cross-defendant for damages claimed by the plaintiffs, if any such damages are found to exist, and declarations of the amount that each cross-defendant is obligated to indemnify McKesson if McKesson is compelled to pay any sum as the result of any damages, judgment or other awards recovered by the plaintiffs against McKesson. On June 8, 2004, WebMD filed a demurrer, seeking dismissal of McKesson's claims.

On July 22, 2004, the Court sustained WebMD's demurrer to the plaintiffs' claims against WebMD, finding that the plaintiffs' claims against WebMD are time barred. On September 10, 2004, the Court sustained WebMD's demurrer to McKesson's cross-complaint.

On September 13, 2004, McKesson Corp. filed a motion for leave to amend its cross-complaint against WebMD. On September 20, McKesson Corp. filed a motion for reconsideration of the Court's ruling on WebMD's demurrer. These motions, along with WebMD's motion for entry of judgment on the demurrer ruling, are pending before the Court.

On October 6, 2004, the original plaintiffs in the California Action, Merrill Lynch Fundamental Growth Fund, Inc. and Merrill Lynch Global Value Fund, Inc., served WebMD with a new complaint filed in the Superior Court of New Jersey, Middlesex County, alleging fraud, aiding and abetting and conspiracy to commit fraud, and negligent misrepresentation, based on essentially the same allegations that they made in the California Action. WebMD intends to vigorously defend this action.

**At Home Corporation General Unsecured Creditors Trust**

As more fully described in Part I, Item 3 of our 2003 Annual Report on Form 10-K (and as previously updated in Part II, Item 1 of our Quarterly Report on Form 10-Q for the quarter ended March 31, 2004), on December 4, 2003, WebMD was served with a complaint in an adversary proceeding in the Bankruptcy Court for the Northern District of California brought by the trustee for the At Home Corporation General Unsecured Creditors Trust alleging, among other things, breach of contract. Although

**Table of Contents**

the plaintiff originally claimed that its damages were in excess of \$8 million, the plaintiff later increased its claim of damages to up to \$39 million. On September 21, 2004, WebMD settled this matter for \$150 thousand.

**Investigations by United States Attorney for the District of South Carolina and the SEC**

As previously disclosed, the United States Attorney for the District of South Carolina is conducting an investigation of our company, which we first learned about on September 3, 2003. On that date, Federal Bureau of Investigation and Internal Revenue Service agents executed search warrants at our corporate headquarters in Elmwood Park, New Jersey and the offices of Medical Manager Health Systems in Tampa, Florida and Alachua, Florida and delivered subpoenas for documents and financial records. Based on the information available to us, we believe that the investigation relates principally to issues of financial accounting improprieties for Medical Manager Corporation, a predecessor of WebMD (by its merger into WebMD in September 2000), and our Medical Manager Health Systems subsidiary; however, we cannot be sure of the investigation's exact scope or how long it will continue. Included among the materials removed or subject to subpoena are records relating to a \$5.5 million restatement of revenue by Medical Manager Corporation in August 1999 and to acquisitions by our Medical Manager Health Systems subsidiary of other companies, most of which were dealers of Medical Manager products and services. In August 1999, Medical Manager Corporation announced that it would restate previously reported results of Medical Manager Health Systems, which it had acquired in July 1999, for the six months ended immediately prior to the acquisition. Medical Manager Corporation determined at the time that the accounting treatment previously accorded to five transactions involving the bulk sales of software licenses entered into concurrently with business combinations and other related transactions should be restated to reflect the software license revenues as a reduction of the acquisition price of the related transactions. At the time, Medical Manager Corporation also noted that the transactions represented \$5,532,000 of revenue and \$3,502,000 of net income for the six months ended June 30, 1999.

WebMD has been cooperating and intends to continue to cooperate fully with the U.S. Attorney's Office. As previously reported, our Board of Directors has formed a special committee consisting solely of independent directors to oversee this matter with the sole authority to direct WebMD's response to the allegations that have been raised. The Special Committee has retained independent legal counsel to advise it. WebMD has retained counsel to advise it in connection with the investigation and such counsel reports directly to the Special Committee.

In connection with this matter, WebMD has uncovered evidence that, prior to Medical Manager's acquisition by WebMD Corporation in September 2000, Medical Manager's dealer acquisition program was improperly used to artificially inflate the revenue, earnings and goodwill of Medical Manager. Also, as we have stated in the past, WebMD has evidence of kickback payments by former dealers to certain former employees of Medical Manager who were responsible for the acquisition program. WebMD has commenced lawsuits against two of those former employees. These kickback payments appear to have continued until sometime in 2002. To date, we have not uncovered information which we believe would require a restatement for any of the years covered by our financial statements. The amount of the kickback payments were immaterial and have already been reflected in our financial statements.

It is our understanding that the investigation by the U.S. Attorney's Office also relates to allegations of improper revenue recognition practices in connection with system sales in the Medical Manager business. WebMD has identified evidence that some employees had in the past engaged in practices to improperly recognize revenue in connection with system sales. As with the issues relating to the dealer acquisition program, to date we have not uncovered information which would require a restatement for any of the years covered by our financial statements.

As previously disclosed, WebMD understands that the SEC is also conducting a formal investigation into this matter.

While WebMD is not able to estimate, at this time, the amount of the expenses that it will incur in connection with the investigations, it expects that they may continue to be significant. For the three and

**Table of Contents**

nine month periods ended September 30, 2004 and 2003, those expenses are reflected as Legal Expense in the Consolidated Statements of Operations included in this Quarterly Report.

**ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds**

(b) The following table provides information about purchases by WebMD during the three months ended September 30, 2004 of equity securities that are registered by us pursuant to Section 12 of the Exchange Act:

**Issuer Purchases of Equity Securities**

<b>Period</b>	<b>Total Number of Shares Purchased</b>	<b>Average Price Paid per Share</b>	<b>Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs(1)</b>	<b>Maximum Number (or Approximate Dollar Value) of Shares that May Yet Be Purchased Under the Plans or Programs(1)</b>
07/01/04-07/31/04	650,356	\$8.16	650,356	\$33,458,075
08/01/04-08/31/04	1,581,000	\$7.47	1,581,000	\$71,647,638
09/01/04-09/30/04	40,000	\$6.83	40,000	\$71,374,334
<b>Total</b>	<b>2,271,356</b>	<b>\$7.66</b>	<b>2,271,356</b>	<b>\$71,374,334</b>

(1) These repurchases were made pursuant to the repurchase program that we announced on March 29, 2001, under which WebMD was originally authorized to use up to \$50 million to purchase shares of its common stock from time to time beginning on April 2, 2001. On November 2, 2001, the maximum aggregate amount of purchases under the Program was increased to \$100 million; on November 7, 2002, it was increased to \$150 million; and on August 19, 2004, it was increased to \$200 million.

**ITEM 4. Submission of Matters to a Vote of Security Holders**

At our Annual Meeting of Stockholders held on September 23, 2004, our common stockholders voted with respect to the following matters:

Proposal 1 To elect as Class III directors to serve three-year terms ending in 2007:

Mark J. Adler, M.D.	votes for	281,888,513
	votes withheld	11,806,744
Herman Sarkowsky	votes for	286,147,377
	votes withheld	7,547,880

Proposal 2 To approve amendments to WebMD's Certificate of Incorporation to provide certain voting rights to the holders of Convertible Redeemable Exchange Preferred Stock and to insert a sentence reciting the total number of shares of all capital stock that WebMD is authorized to issue:

Votes for:	185,527,545
Votes against:	6,578,431
Abstentions:	429,089
Broker non-votes:	101,160,192



**Table of Contents**

Proposal 3 To approve amendments to WebMD's Certificate of Incorporation to reduce the number of authorized shares of Convertible Redeemable Exchangeable Preferred Stock from 5,000,000 to 10,000:

Votes for:	184,409,109
Votes against:	7,687,296
Abstentions:	429,660
Broker non-votes:	101,169,192

Proposal 4 To approve amendments to WebMD's Certificate of Incorporation to clarify the authority of WebMD's Board of Directors to designate and authorize the issuance of new series of preferred stock with voting powers by creating a new class of 4,990,000 shares of preferred stock describing such authority with specificity:

Votes for:	171,113,364
Votes against:	20,975,376
Abstentions:	437,324
Broker non-votes:	101,169,192

Proposals 2 and 3 were also voted on by our Convertible Redeemable Exchangeable Preferred Stock, all 10,000 shares of which were voted for each of Proposals 2 and 3.

In addition to the directors elected at the Annual Meeting, our Board of Directors consists of: Neil F. Dimick, Roger C. Holstein and Joseph E. Smith, whose terms expire in 2005; Paul A. Brooke, James V. Manning and Martin J. Wygod, whose terms expire in 2006; and Kevin Cameron, whose term expires in 2007.

**ITEM 6. Exhibits**

The exhibits listed in the accompanying Exhibit Index on page E-1 are filed or furnished as part of this Quarterly Report.

**Table of Contents**

**SIGNATURES**

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

WEBMD CORPORATION

By: /s/ ANDREW C. CORBIN

---

Andrew C. Corbin  
*Executive Vice President and Chief  
Financial Officer*

Date: November 9, 2004

**Table of Contents****EXHIBIT INDEX**

<b>Exhibit No.</b>	<b>Description</b>
3.1	Eleventh Amended and Restated Certificate of Incorporation of Registrant, as amended
3.2	Certificate of Designations for Convertible Redeemable Exchangeable Preferred Stock, as amended
3.3	Amended and Restated Bylaws of Registrant (incorporated by reference to Exhibit 3.3 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2004)
10.1	2004 Non-Qualified Stock Option Plan for Employees of Dakota Imaging, Inc.
10.2	2004 Non-Qualified Stock Option Plan for Employees of VIPS, Inc.
31.1	Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer of Registrant
31.2	Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer of Registrant
32.1	Section 1350 Certification of Chief Executive Officer of Registrant
32.2	Section 1350 Certification of Chief Financial Officer of Registrant

E-1