HMS HOLDINGS CORP
Form 10-Q
November 09, 2012
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2012

Or

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

For the transition period from to

Commission File Number 000-50194

HMS HOLDINGS CORP.

(Exact name of registrant as specified in its charter)

New York	**11-3656261**
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
401 Park Avenue South, New York, NY	**10016**
(Address of principal executive offices)	(Zip Code)

(Registrant s Telephone Number, Including Area Code)

(212) 725-7965

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for shorter period that the registrant was required to submit and post such files). x Yes o No

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

Large accelerated filer x	Accelerated filer o
Non-accelerated filer o	Smaller reporting company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No x

As of November 6, 2012, there were approximately 86,917,904 shares of the registrant s common stock (par value $0.01 per share) outstanding.

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HMS HOLDINGS CORP. AND SUBSIDIARIES

QUARTERLY REPORT ON FORM 10-Q

FOR THE QUARTER ENDED SEPTEMBER 30, 2012

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Special Note Regarding Forward-Looking Statements

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of the U.S. Private Securities Litigation Reform Act of 1995. From time to time, we also provide forward-looking statements in other materials we release to the public, as well as oral forward-looking statements. Such statements give our expectations or forecasts of future events; they do not relate strictly to historical or current facts.

We have tried, wherever possible, to identify such statements by using words such as anticipate, estimate, expect, project, intend, plan, believe, will, target, seek, forecast and similar expressions. In particular, these include statements relating to future actions, business plans, objects and prospects, future operating or financial performance or results of current and anticipated services, acquisitions and the performance of companies we have acquired, sales efforts, expenses, interest rates, and the outcome of contingencies, such as financial results.

We cannot guarantee that any forward-looking statement will be realized. Forward-looking statements are based on our current expectations and assumptions regarding our business, the economy and other future conditions. Should known or unknown risks or uncertainties materialize, or should underlying assumptions prove inaccurate, actual results could differ materially from past results and those anticipated, estimated or projected. We caution you, therefore, against relying on any of these forward-looking statements. They are neither statements of historical fact nor guarantees or assurances of future performance. Factors that could cause or contribute to such differences include, but are not limited to, those discussed in our Annual Report on Form 10-K, and in particular, the risks discussed under the heading Risk Factors in Part I, Item 1A of our Annual Report on Form 10-K, Part II of this 10-Q and those discussed in other documents we file with the Securities and Exchange Commission.

Any forward-looking statements made by us in this Report on Form 10-Q speak only as of the date on which they are made. Factors or events that could cause actual results to differ may emerge from time to time and it is not possible for us to predict all of them. We undertake no obligation to publicly update forward-looking statements, whether as a result of new information, future events or otherwise, except as may be required by law. You are advised, however, to consult any further disclosures we make on related subjects in our filings with the Securities and Exchange Commission, including but not limited to our Current Reports on Form 8-K.

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HMS HOLDINGS CORP. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(in thousands, except share and per share amounts)

(unaudited)

	September 30, 2012	December 31, 2011
Assets		
Current assets:		
Cash and cash equivalents	$ 127,952	$ 97,003
Accounts receivable, net of allowance of $811 at September 30, 2012 and $1,158 at December 31, 2011	115,854	112,505
Prepaid expenses	11,528	6,602
Prepaid income taxes	9,467	2,418
Current portion of deferred financing costs	3,431	3,689
Other current assets	434	5,793
Net deferred tax asset	2,029	2,198
Total current assets	270,695	230,208
Property and equipment, net	124,435	127,177
Goodwill, net	361,642	361,786
Intangible assets, net	116,006	132,740
Deferred financing costs	6,668	9,203
Other assets	3,949	837
Total assets	$ 883,395	$ 861,951
Liabilities and Shareholders Equity		
Current liabilities:		
Accounts payable, accrued expenses and other liabilities	$ 31,711	$ 40,546
Acquisition related contingent consideration		2,300
Current portion of term loan	30,625	17,500
Total current liabilities	62,336	60,346
Long-term liabilities:		
Deferred rent	545	1,085
Term loan	306,250	332,500
Other liabilities	2,778	2,423
Deferred tax liabilities	68,419	74,360
Total long-term liabilities	377,992	410,368
Total liabilities	440,328	470,714
Shareholders equity:		
Preferred stock - $0.01 par value; 5,000,000 shares authorized; none issued		
Common stock - $0.01 par value; 125,000,000 shares authorized; 92,096,518 shares issued and 86,671,671 shares outstanding at September 30, 2012; 90,575,837 shares issued and 85,587,299 shares outstanding at December 31, 2011	921	906
Capital in excess of par value	272,143	240,241
Retained earnings	190,017	159,487
Treasury stock, at cost: 5,424,847 shares at September 30, 2012 and 4,988,538 shares at December 31, 2011	(20,014)	(9,397)
Total shareholders equity	443,067	391,237
Total liabilities and shareholders equity	$ 883,395	$ 861,951

See accompanying notes to unaudited consolidated financial statements.

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HMS HOLDINGS CORP. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in thousands, except per share amounts)

(unaudited)

	Three months ended September 30, 2012	Three months ended September 30, 2011	Nine months ended September 30, 2012	Nine months ended September 30, 2011
Revenue	$ 113,217	$ 92,356	$ 340,600	$ 264,159
Cost of services:				
Compensation	40,170	31,762	119,489	94,604
Data processing	7,871	5,973	22,791	16,607
Occupancy	4,428	3,794	12,742	11,328
Direct project costs	14,530	9,893	40,573	30,546
Other operating costs	3,198	4,637	14,311	13,448
Amortization of acquisition related software and intangibles	8,149	1,660	24,447	5,048
Total cost of services	78,346	57,719	234,353	171,581
Selling, general and administrative expenses	14,158	10,560	43,897	31,932
Total operating expenses	92,504	68,279	278,250	203,513
Operating income	20,713	24,077	62,350	60,646
Interest expense	(4,125)	(19)	(12,488)	(65)
Other income, net	27	165	346	714
Interest income	13	14	17	50
Income before income taxes	16,628	24,237	50,225	61,345
Income taxes	6,121	9,822	19,695	24,691
Net income and comprehensive income	$ 10,507	$ 14,415	$ 30,530	$ 36,654
Basic income per common share				
Net income per share basic	$ 0.12	$ 0.17	$ 0.35	$ 0.43
Diluted income per share				
Net income per share diluted	$ 0.12	$ 0.17	$ 0.35	$ 0.42
Weighted average shares:				
Basic	86,405	84,159	86,010	84,372
Diluted	88,744	86,869	88,399	87,233

See accompanying notes to unaudited consolidated financial statements.

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HMS HOLDINGS CORP. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY

For the Nine Months Ended September 30, 2012

(in thousands, except share amounts)

(unaudited)

	Common Stock		Capital in		Treasury Stock		Total
	# of Shares Issued	Par Value	Excess of Par Value	Retained Earnings	# of Shares	Amount	Shareholders Equity
Balance at December 31, 2011	90,575,837	$ 906	$ 240,241	$ 159,487	4,988,538	$ (9,397)	$ 391,237
Net income and comprehensive income				30,530			30,530
Stock-based compensation cost			10,194				10,194
Purchase of Treasury Stock					436,309	(10,617)	(10,617)
Exercise of stock options	1,451,701	14	10,977				10,991
Vesting of restricted stock awards and units, net of shares withheld for employee tax	68,980	1	(1,128)				(1,127)
Excess tax benefit from exercise of stock options			11,859				11,859
Balance at September 30, 2012	92,096,518	$ 921	$ 272,143	$ 190,017	5,424,847	$ (20,014)	$ 443,067

See accompanying notes to unaudited consolidated financial statements.

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HMS HOLDINGS CORP. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CASH FLOWS

(in thousands)

(unaudited)

	Nine months ended September 30, 2012	2011
Operating activities:		
Net income	$ 30,530	$ 36,654
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	40,929	14,930
Stock-based compensation expense	10,194	5,884
Excess tax benefit from exercised stock options	(11,859)	(8,157)
Deferred income taxes	(5,772)	1,508
Decrease in allowance for doubtful debts	(347)	(149)
Change in fair value of contingent consideration	(2,300)	391
Loss on disposal of fixed assets	62	5
Changes in operating assets and liabilities:		
Accounts receivable	(3,002)	(10,371)
Prepaid expenses	(4,926)	(839)
Prepaid income taxes	4,810	11,690
Other current assets	550	(388)
Other assets	(88)	57
Accounts payable, accrued expenses and other liabilities	(3,861)	(2,125)
Net cash provided by operating activities	54,920	49,090
Investing activities:		
Investment in certificate of deposit		(4,809)
Proceeds from redemption of certificate of deposit	4,809	
Purchases of property and equipment	(20,323)	(13,092)
Investment in common stock	(3,024)	
Acquisitions, net	(1,605)	(339)
Investment in capitalized software	(1,559)	(1,502)
Net cash used in investing activities	(21,702)	(19,742)
Financing activities:		
Repayment of term loan	(13,125)	
Purchases of treasury stock	(10,617)	
Payments on contingent consideration	(250)	
Proceeds from exercise of stock options	10,991	9,013
Payments of tax withholdings on behalf of employees for net-share settlement for stock-based compensation	(1,127)	(903)
Excess tax benefit from exercised stock options	11,859	8,157
Net cash (used in)/provided by financing activities	(2,269)	16,267
Net increase in cash and cash equivalents	30,949	45,615
Cash and cash equivalents at beginning of period	97,003	94,836
Cash and cash equivalents at end of period	$ 127,952	$ 140,451
Supplemental disclosure of cash flow information:		
Cash paid for income taxes	$ 20,762	$ 11,547
Cash paid for interest	$ 10,093	$ 89
Supplemental disclosure of noncash investing activities:		
Accrued property and equipment purchases	$ 267	$ 438

Accrued acquisition related contingent consideration	$	$	351

See accompanying notes to unaudited consolidated financial statements.

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HMS HOLDINGS CORP. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

For the Three and Nine Months Ended September 30, 2012 and 2011

(unaudited)

1. Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. Generally Accepted Accounting Principles, or U.S. GAAP, for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by U.S. GAAP for complete financial statements. In the opinion of management, the unaudited interim financial statements furnished herein include all adjustments necessary (consisting only of normal recurring adjustments) for a fair presentation of our and our subsidiaries financial position at September 30, 2012, the results of our operations for the three and nine months ended September 30, 2012 and 2011 and cash flows for the nine months ended September 30, 2012 and 2011. Interim financial statements are prepared on a basis consistent with our annual financial statements. The financial statements included herein should be read in conjunction with the financial statements and notes included in our Annual Report on Form 10-K for the year ended December 31, 2011, which we refer to as our Annual Report.

We provide cost containment services to government and private healthcare payers and sponsors. Our services ensure that healthcare claims are paid correctly, through our program integrity services, and by the responsible party, through our coordination of benefits services. Our services help clients recover amounts from liable third parties; prevent future inappropriate payments; reduce fraud, waste and abuse; and ensure regulatory compliance.

In September 2008, we purchased the assets and liabilities of Prudent Rx, expanding our portfolio of program integrity service offerings for government healthcare programs and managed care organizations, particularly in the pharmacy arena. In September 2009, we further expanded our portfolio of program integrity service offerings for government healthcare programs, particularly in the Medicare and Medicaid programs with our acquisition of IntegriGuard LLC, or IntegriGuard. In December 2009, with the acquisition of Verify Solutions, Inc., or Verify Solutions, we moved into the employer-based market with valuable new services that ensure that dependents covered by employees are eligible to receive healthcare benefits. In June 2010, we acquired Allied Management Group Special Investigation Unit or AMG-SIU, which provides fraud, waste and abuse prevention and detection solutions for healthcare payers. In August 2010, we acquired Chapman Kelly, Inc., or Chapman Kelly which provides claims audit and beneficiary eligibility audit services to employers and managed care organizations. In December 2011, we acquired HDI Holdings, Inc. and its operating subsidiary, HealthDataInsights, Inc., or HDI. HDI offers a comprehensive suite of claims integrity services, including complex medical reviews, automated reviews, hospital bill audits, and pharmacy audits. The acquisition of HDI extended our reach in the federal, state and commercial markets and provided us with a platform to expand service offerings to our existing clients.

These consolidated financial statements include our accounts and transactions and those of our wholly owned subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation.

We are managed and operated as one business, with a single management team that reports to the Chief Executive Officer. We do not operate separate lines of business with respect to any of our product lines.

The preparation of the consolidated financial statements in conformity with U.S. GAAP requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities, primarily accounts receivable, intangible assets, accrued expenses, and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenue and expenses during the reporting periods. Our actual results could differ from those estimates.

We consider all highly liquid instruments with an original maturity of three months or less to be cash equivalents. Cash equivalents consist of deposits that are readily convertible into cash.

Our financial instruments are categorized into a three-level fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The fair value hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). If the inputs used to measure fair value fall within different levels of the hierarchy, the category level is based on the lowest priority level input that is significant to the fair value measurement of the instrument. In the event the fair value is not readily available/determinable, the financial instrument is carried at cost and referred to as a cost method investment. The evaluation of whether an investment s fair value is less than cost is determined by using a disclosed fair value estimate, if one is available, otherwise, it is determined by

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evaluating whether an event or change in circumstances has occurred that may have a significant adverse effect on the fair value of the investment (an impairment indicator).We are not aware of any identified events or change in circumstances that would have a significant adverse effect on the carrying value of our cost method investments. Financial instruments recorded at fair value on our consolidated balance sheets are categorized as follows:

- Level 1: Observable inputs such as quoted prices in active markets;
- Level 2: Inputs, other than the quoted prices in active markets, that are observable either directly or indirectly; and
- Level 3: Unobservable inputs in which there is little or no market data, which require the reporting entity to develop its own assumptions.

Our policy is to limit our credit exposure by placing our investments with financial institutions evaluated as being creditworthy, or in short-term money market funds which are exposed to minimal interest rate and credit risk. We maintain our cash in cash depository accounts and certificate of deposits within large financial institutions. The balance in certain of these accounts exceeds the maximum balance insured by the Federal Deposit Insurance Corporation of up to $250,000 per bank account. We have not experienced any losses on our bank deposits and we believe these deposits do not expose us to any significant credit risk.

We are subject to potential credit risk related to changes in economic conditions within the healthcare market. However, we believe that our billing and collection policies are adequate to minimize the potential credit risk.

We evaluate the recoverability of goodwill and long-lived assets either annually or whenever events or changes in circumstances indicate that an asset s carrying amount may not be recoverable. Such circumstances could include, but are not limited to (i) a significant decrease in the market value of an asset, (ii) a significant adverse change in the extent or manner in which an asset is used, or (iii) an accumulation of costs significantly in excess of the amount originally expected for the acquisition of an asset.

For long-lived assets, we measure the carrying amount of the asset against the estimated undiscounted future cash flows associated with it. If the sum of the expected future net cash flows is less than the carrying value of the asset being evaluated, an impairment charge would be recognized. The impairment charge would be calculated as the amount by which the carrying value of the asset exceeds its fair value. The determination of fair value is based on quoted market prices, if available. If quoted market prices are not available, the estimate of fair value is based on various valuation techniques, including the discounted value of estimated future cash flows. We did not recognize any impairment charges related to our long-lived assets, property and equipment, goodwill or intangible assets, during the nine months ended September 30, 2012 and 2011, as management believes that carrying amounts were not impaired.

The carrying amounts for our cash equivalents, accounts receivable, accounts payable and accrued expenses approximate fair value due to their short-term nature.

In May 2012, our Board of Directors authorized management to repurchase shares of our common stock pursuant to a previously approved Share Repurchase Plan. Under the Plan, we repurchased 4,988,538 shares in 1997, at an average price of $1.88 per share. In May 2012, we repurchased an additional 436,309 shares at an average price of $24.29 per share and completed the Share Repurchase Plan. Repurchased shares will be available for use in connection with our stock plans and for other corporate purposes.

On October 29, 2012, our Board of Directors authorized management to repurchase up to $50.0 million of our common stock from time to time on the open market or in privately negotiated transactions, for a period of up to two years. Repurchased shares will be available for use in connection with our stock plans and for other corporate purposes.

Recently Issued Accounting Pronouncements

In May 2011, Financial Accounting Standards Board, or FASB, issued authoritative accounting guidance for updates on Fair Value Measurements, specifically, Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and International Financial Reporting Standards. This update amends Accounting Standards Codification (ASC) Topic 820, Fair Value Measurement and Disclosure, clarifies the application of certain existing fair value measurement guidance and expands the disclosures for fair value measurements that are estimated using significant unobservable (Level 3) inputs. This authoritative guidance is effective for annual and interim reporting periods beginning on or after December 15, 2011. This new guidance is to be adopted prospectively and early adoption is not permitted. The adoption of this guidance did not have a material effect on our consolidated financial statements.

In June 2011, FASB issued Accounting Standards Update (ASU) No. 2011-05 for the presentation of comprehensive income thereby amending ASC 220, *Comprehensive Income.* The amendment requires that all non-owner changes in stockholder s equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The

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amendment is effective for fiscal years beginning after December 15, 2011 and should be applied retrospectively. The adoption of this guidance did not have a material effect on our consolidated financial statements.

In September 2011, the FASB issued ASU No. 2011-08, Testing Goodwill for Impairment (the revised standard). Under the amendments in this ASU, an entity has an option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If, after assessing the totality of events or circumstances, an entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step impairment test is unnecessary. This ASU is effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. Early adoption is permitted. The adoption of this guidance did not have a material effect on our consolidated financial statements.

2. Acquisitions

The results of operations for our acquisitions have been included in our consolidated financial statements from the respective dates of acquisition.

HDI Holdings, Inc.

In December 2011, we purchased all of the issued and outstanding common stock of privately-held HDI for an aggregate consideration of $370.4 million, of which $366.6 million was cash. $40.0 million of the purchase price was placed in an indemnity escrow account through November 7, 2012, at which time, $36.6 million was released. The remainder is being held in escrow pending the disposition of a potential covered loss. In connection with acquisition, we issued replacement option awards with an aggregate fair value of $14.3 million, of which $3.8 million is attributable to the purchase price. The fair value of the replacement option awards and the amount included in the purchase price was calculated using a Black-Scholes model as of the acquisition date. These awards have vesting schedules of 1-48 months and the portion of the fair value of these awards that is not attributable to the purchase price is being expensed over the applicable vesting period.

Based in Las Vegas, Nevada, HDI provides improper payment identification services for government and commercial health plans, and is the Medicare RAC in CMS Region D, covering 17 states and three U.S. territories. HDI offers a comprehensive suite of claims integrity services, including complex medical reviews, automated reviews, hospital bill audits, and pharmacy audits.

The following table summarizes the estimated fair values of the assets acquired and liabilities assumed at the acquisition date (*in thousands*):

	December 16, 2011 (As initially reported)	Measuring Period Adjustments	December 16, 2011 (As Adjusted)
Cash and cash equivalents	$ 15,113		$ 15,113
Accounts receivable	13,190		13,190

Other current assets	1,358		1,358
Deferred income taxes	4,454		4,454
Property, plant and equipment	74,741	398	75,139
Intangible assets	119,500	1,600	121,100
Other assets	45		45
Total identifiable assets acquired	228,401	1,998	230,399
Accounts payable	332		332
Accrued expenses	2,210		2,210
Deferred income taxes	69,694		69,694
Long-term debt	39,480		39,480
Contingent consideration		250	250
Other liabilities	2,645		2,645
Total liabilities assumed	114,361	250	114,611
Net identifiable assets acquired	114,040	1,748	115,788
Goodwill	254,761	(144)	254,617
Net assets acquired	$ 368,801	1,604	$ 370,405

In March 2012, upon finalization of net working capital adjustments related to the acquisition, we made an additional payment of $1.6 million to the former shareholders of HDI.

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The above estimated fair values of assets acquired and liabilities assumed are provisional. They are based on the information that was available as of the acquisition date and as of September 30, 2012. We believe that this information provides a reasonable basis for estimating the fair values but we are still waiting for additional information necessary to finalize these amounts; as a result, the provisional measurements of fair value reflected above are subject to change. Such changes could be significant. We expect to finalize the valuation and complete the purchase price allocation as soon as practicable, but no later than one year from the date of acquisition. The measurement period adjustments reflected above would have had a de minimis effect on the financial statements for the year ended December 31, 2011.

The following table summarizes the preliminary fair values of the intangible assets acquired from HDI as of September 30, 2012 (*in thousands*):

		Fair Value	Useful Life
Client relationships	$	88,500	7 - 10 years
Restrictive covenants		16,800	5 years
Trade name		15,800	7 years
Total	$	121,100	

We recognized $254.6 million of goodwill in connection with our acquisition of HDI, which is primarily attributable to expected synergies and HDI s assembled workforce. We recognized $5.2 million of acquisition-related costs that were expensed during the year ended December 31, 2011. These costs are included in selling, general and administration expenses in the Consolidated Statements of Comprehensive Income for the year ended December 31, 2011.

The following represents our pro forma Consolidated Statements of Comprehensive Income as if HDI had been included in our consolidated results for the three and nine months ending September 30, 2011 (*in thousands, except per share data*):

(unaudited)		For the three months ending September 30, 2011		For the nine months ending September 30, 2011
Total revenue	$	108,962	$	306,348
Net income	$	13,110	$	28,549
Earnings per share:				
Basic	$	0.16	$	0.34
Diluted	$	0.15	$	0.32

These amounts have been calculated after applying our accounting policies and adjusting HDI s results to reflect the additional depreciation, amortization and interest expense that would have been charged assuming the fair value adjustments to property, plant and equipment and intangible assets had been applied on January 1, 2011, together with the consequential tax effects.

Allied Management Group - Special Investigation Unit, Inc.

In June 2010, we purchased all of the common stock of AMG-SIU for an aggregate purchase price of $15.1 million, consisting of a $13.0 million initial cash payment (subsequently reduced by a working capital reduction of $0.2 million) and future contingent payments estimated at

$2.3 million and recognized as a contingent payment liability on our balance sheet as of the acquisition date. At closing, $3.5 million of the purchase price was held in escrow to be released in three annual payments: $1.8 million in July 2011 and $875,000 in July 2012 and 2013, of which the $1.8 million for 2011 has been released and the remainder is being held in escrow pending the resolution of certain potential covered losses. The future contingent payments were based on AMG-SIU s financial performance for each of the twelve month periods ending June 30, 2012 and June 30, 2011 and were not subject to a cap. AMG-SIU has not achieved the required financial milestones. We have reversed the $2.3 million contingent payment liability in the quarter ending September 30, 2012 after completing our assessment of certain claims made by the former owners. This amount is included in other operating costs for three and nine months ending September 30, 2012.

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3. Intangible Assets

Intangible assets consisted of the following at September 30, 2012 and December 31, 2011 (*in thousands*):

	September 30, 2012	December 31, 2011	Useful Life
Client relationships	$ 121,486	$ 120,986	5-10 years
Trade name	19,732	18,933	3-7 years
Restrictive covenants	19,426	19,126	3-5 years
	160,644	159,045	
Less accumulated amortization	(44,638)	(26,305)	
Intangible assets, net	$ 116,006	$ 132,740	

Estimated amortization expense for intangible assets is expected to approximate the following (*in thousands*):

Year Ending December 31,	
Remainder of 2012	$ 6,088
2013	22,267
2014	19,325
2015	18,998
2016	18,662
Thereafter	30,666

The changes in the carrying amount of goodwill for the nine months ended September 30, 2012 are as follows (*in thousands*):

Balance at December 31, 2011	$ 361,786
HDI measurement period adjustments	(144)
Balance at September 30, 2012	$ 361,642

For the three months ended September 30, 2012 and 2011, amortization expense related to intangible assets was $6.1 million and $1.5 million, respectively. For the nine months ended September 30, 2012 and 2011, amortization expense related to intangible assets was $18.3 million and $4.4 million, respectively.

4. Income Taxes

Our effective tax rate decreased to 39.3% for the nine months ended September 30, 2012 from 40.3% for the nine months ended September 30, 2011, primarily due to a change in state apportionments and permanent differences. The principal difference between the statutory rate and our effective rate is state taxes and permanent differences.

We file income tax returns with the U.S. federal government and various state jurisdictions. We are no longer subject to U.S. federal income tax examinations for years before 2009. We operate in a number of state and local jurisdictions, most of which have never audited our records. Accordingly, we are subject to state and local income tax examinations based upon the various statutes of limitations in each jurisdiction. We are currently being examined by the States of New York and Idaho. HDI s 2009 federal tax return was examined by the Internal Revenue Service and a closing letter was issued in August 2012 for no change to taxable income.

During the nine months ended September 30, 2012 and 2011, we recorded a tax benefit of $11.8 million and $8.2 million, respectively, related to the utilization of the income tax benefit from stock transactions by reducing income tax payable and increasing capital.

At September 30, 2012 and 2011, we had approximately $1.7 million and $1.3 million, respectively, of net unrecognized tax benefits, for which there is uncertainty about the allocation and apportionment impacting state taxable income. We do not expect any significant change in unrecognized tax benefits during the next twelve months. We have recognized interest accrued related to unrecognized tax benefits in interest expense and penalties in tax expense. The accrued liabilities related to uncertain tax positions were $0.7 million and $0.5 million for the nine month periods ending September 30, 2012 and 2011, respectively. We believe that it is reasonably possible that decreases in unrecognized tax benefits of up to $0.1 million may be recorded within the next year.

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5. Credit Agreement

In connection with our acquisition of HDI in December 2011, we entered into a five year, revolving and term secured credit agreement, which we refer to as the Credit Agreement, with certain financial institutions and Citibank, N.A. as Administrative Agent. The Credit Agreement is guaranteed by our material subsidiaries and is supported by a security interest in all or substantially all of our and our subsidiaries personal property assets. The Credit Agreement, which matures in December 2016, provides for a term loan of $350 million, or the Term Loan, which was used to finance a significant portion of our acquisition of HDI, and a revolving credit facility in an initial amount of $100 million. Under specified circumstances, the revolving credit facility can be increased by up to $50 million in additional term or revolving loan commitments.

The interest rates applicable to both the Term Loan and the revolving credit facility are either (a) the LIBOR multiplied by a statutory reserve rate plus an interest margin ranging from 2.00% to 3.00% based on our consolidated leverage ratio or (b) a base rate plus an interest margin ranging from 1.00% to 2.00% based on our consolidated leverage ratio. The base rate is equal to the greatest of (a) Citibank s prime rate, (b) the federal funds rate plus 0.50% or (c) the one-month LIBOR plus 1.00%. The interest rate at September 30, 2012 was 3.50%. Including debt issuance costs and original issue discounts, the Term Loan has an effective annualized interest rate of approximately 4.8%. In addition, we are required to pay an unused commitment fee on the revolving credit facility during the term of the Credit Agreement of 0.50% per annum.

The Credit Agreement contains certain customary affirmative and negative covenants. The Credit Agreement requires us to comply, on a quarterly basis, with certain principal financial covenants, including a maximum consolidated leverage ratio reducing from 4.00:1.00 to 3.50:1.00 over the next four years and a minimum interest coverage ratio of 3.00:1.00. We were in compliance with the required financial covenants at September 30, 2012. In addition, the Credit Agreement restricts our ability to make certain payments or distributions with respect to our capital stock, including cash dividends to our shareholders, or any payments to purchase, redeem, retire, acquire, cancel or terminate any shares of our capital stock, which we collectively refer to as restricted payments. However, we may make restricted payments (which include cash dividends) in an aggregate annual amount that does not exceed (i) $30,000,000 plus, if our consolidated leverage ratio (as defined in the Credit Agreement and calculated on a pro forma basis) is no greater than 3.00 to 1.00, plus (ii) an additional amount calculated under the Credit Agreement by reference to our then-existing excess cash flow, so long as, in any circumstance, no event of default would occur under the Credit Agreement as a result of making any such restricted payment. In addition, we may pay dividends to our shareholders in shares of our capital stock without limitation.

Our obligations under the Credit Agreement may be accelerated upon the occurrence of an event of default under the Credit Agreement, which includes customary events of default including, without limitation, payment defaults, failure to perform affirmative covenants, failure to refrain from actions or omissions prohibited by negative covenants, the inaccuracy of representations or warranties, cross-defaults, bankruptcy and insolvency related defaults, defaults relating to judgments, defaults due to certain ERISA related events and a change of control default.

The Term Loan requires scheduled quarterly principal payments of $4.4 million through December 31, 2012, $8.8 million through December 31, 2014, $21.8 million through December 31, 2015 and $43.8 million through December 16, 2016. As of September 30, 2012, we had made three quarterly principal payments totaling $13.1 million.

For the nine months ended September 30, 2012, we incurred $9.2 million of interest on the outstanding Term Loan and incurred $0.4 million in commitment fees on the revolving credit facility. The loan origination fee and issuance costs of $12.7 million incurred upon consummation of the Credit Agreement have been recorded as deferred financing costs and are being amortized as interest expense over the five year life of the Credit Agreement using the effective interest method. For the nine months ended September 30, 2012, $2.8 million of the financing cost has been amortized to interest expense.

Although we expect that operating cash flows will continue to be a primary source of liquidity for our operating needs, we have the revolving credit facility, which may be used for general corporate purposes, including acquisitions, available for future cash flow needs, if necessary.

As part of our contractual agreement with a client, we have an outstanding irrevocable letter of credit or Letter of Credit for $4.6 million, which we established against our existing revolving credit facility.

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6. Earnings Per Share

Basic income per share is calculated by dividing net income by the weighted average number of common shares outstanding during the period. Diluted income per share is calculated by dividing net income by the weighted average number of common shares and dilutive common share equivalents outstanding during the period. Our common share equivalents consist of stock options and restricted stock awards and units.

The following table reconciles the basic to diluted weighted average shares outstanding using the treasury stock method (*shares in thousands*):

	Three months ended September 30,		Nine months ended September 30,	
	2012	**2011**	**2012**	**2011**
Weighted average shares outstanding basic	86,405	84,159	86,010	84,372
Dilutive effect of stock options	2,036	2,579	2,107	2,721
Dilutive effect of restricted stock awards and units	303	131	282	140
Weighted average shares outstanding - diluted	88,744	86,869	88,399	87,233

For the three months ended September 30, 2012 and 2011, 145,510 and 210,776 stock options, respectively, were not included in the diluted earnings per share calculation because the effect would have been anti-dilutive.

For the nine months ended September 30, 2012 and 2011, 204,376 and 206,649 stock options, respectively, were not included in the diluted earnings per share calculation because the effect would have been anti-dilutive. For the nine months ended September 30, 2012 and 2011, restricted stock units representing 50,722 and 41,574 shares of common stock, respectively, were not included in the diluted earnings per share calculation because the effect would have been anti-dilutive.

7. Stock-Based Compensation

Total stock-based compensation expense charged as a selling, general and administrative expense in our consolidated statements of comprehensive income related to our stock compensation plans was $3.1 million and $1.9 million for the three months ended September 30, 2012 and September 30, 2011, respectively, and $10.2 million and $5.9 million for the nine months ended September 30, 2012 and September 30, 2011, respectively.

The total income tax benefit related to stock-based compensation expense recognized in our consolidated statements of comprehensive income was $5.0 million and $1.2 million, for the three months ended September 30, 2012 and 2011, respectively, and $11.8 million and $8.2 million, for the nine months ended September 30, 2012 and 2011, respectively.

Presented below is a summary of our stock option activity for the nine months ended September 30, 2012 (*shares in thousands*):

	Shares		Weighted Average Exercise Price	Weighted Average Remaining Contractual Terms		Aggregate Intrinsic Value
Outstanding at December 31, 2011	6,296	$	11.07			
Granted	8	$	24.38			
Exercised	(1,453)	$	7.61			
Forfeitures	(136)	$	17.21			
Expired						
Outstanding at September 30, 2012	4,715	$	11.99	4.57	$	100,891
Expected to vest at September 30, 2012	2,289	$	17.62	5.62	$	36,078
Exercisable at September 30, 2012	2,360	$	6.37	3.53	$	63,773

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The fair value of each option grant was estimated using the Black-Scholes option pricing model. Expected volatilities are calculated based on the historical volatility of our common stock. Management monitors stock option exercises and employee termination patterns to estimate forfeiture rates within the valuation model. Separate groups of employees that have similar historical exercise behavior are considered separately for valuation purposes. The expected holding period of options represents the period of time that options granted are expected to be outstanding. The expected terms of options granted are based upon our historical experience for similar types of stock option awards. The risk-free interest rate is based on U.S. Treasury Notes.

We estimated the fair value of each stock option grant on the date of grant using a Black-Scholes option-pricing model and the weighted-average assumptions set forth in the following table:

	Nine months ended September 30,	
	2012	**2011**
Expected dividend yield		
Risk-free interest rate	0.70%	3.04%
Expected volatility	41.35%	43.70%
Expected life	4.47 years	4.00 years

During the three months ended September 30, 2012 and 2011, we issued 0.5 million shares, and 0.3 million shares, respectively, of our common stock upon the exercise of outstanding stock options and received proceeds of $3.5 million, and $1.3 million, respectively. For the three months ended September 30, 2012 and 2011, we realized a tax benefit of $5.0 million and $1.2 million, respectively from the exercise of stock options.

We issued 1.5 million shares of our common stock upon the exercise of outstanding stock options for each of the nine month periods ended September 30, 2012 and 2011, and received proceeds of $11.0 million, and $9.0 million, respectively. For the nine months ended September 30, 2012 and 2011, we realized $11.8 million and $8.2 million, respectively, in tax benefits from the exercise of stock options.

For the three months ended September 30, 2012, and 2011, approximately $2.1 million, and $1.2 million, respectively, of stock-based compensation cost relating to stock options has been charged against income. For the nine months ended September 30, 2012, and 2011, approximately $7.3 million, and $3.7 million, respectively, of stock-based compensation cost relating to stock options has been charged against income. As of September 30, 2012, there was approximately $15.2 million of total unrecognized compensation cost, adjusted for estimated forfeitures, related to stock options outstanding, which is expected to be recognized over a weighted-average period of 1.1 years.

The aggregate intrinsic value in the previous table reflects the total pretax intrinsic value (the difference between our closing stock price on the last trading day of the period and the exercise price of the options, multiplied by the number of in-the-money stock options) that would have been received by the option holders had all option holders exercised their options on September 30, 2012. The intrinsic value of our stock options changes based on the closing price of our common stock. The total intrinsic value of options exercised (the difference in the market price of our common stock on the exercise date and the price paid by the optionee to exercise the option) for the three months ended September 30, 2012 and 2011 was approximately $14.1 million and $5.6 million, respectively. The total intrinsic value of options exercised during the nine month periods ended September 30, 2012 and 2011 was $35.1 million and $28.8 million, respectively.

Restricted Stock Units

Our non-employee members of the Board and certain employees have received restricted stock units under our 2006 Stock Plan, as amended. The fair value of restricted stock units is estimated based on the closing sale price of our common stock on the NASDAQ Global Select Market on the date of issuance. The total number of restricted stock units expected to vest is adjusted by estimated forfeiture rates.

For the three months ended September 30, 2012, we granted 504 restricted stock units, with an aggregate fair market value of $17,000. For the nine months ended September 30, 2012, we granted 4,623 restricted stock units, with an aggregate fair market value of $0.1 million. At September 30, 2012, 448,166 restricted stock units remained unvested and there was $7.1 million of unamortized compensation cost related to restricted stock units, which is expected to be recognized over the remaining weighted-average vesting period of 1.6 years. Stock-based compensation expense related to restricted stock units was $0.8 million and $0.6 million for the three months ended September 30, 2012 and 2011, respectively and $2.3 million and $1.5 million for the nine months ended September 30, 2012 and 2011, respectively.

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A summary of the status of our restricted stock units as of September 30, 2012 and of changes in restricted stock units outstanding under the 2006 Stock Plan, as amended, for the nine months ended September 30, 2012 is as follows (*in thousands, except for weighted average grant date fair value per unit*):

	Number of Units		Weighted Average Grant Date Fair Value per Unit		Aggregate Intrinsic Value
Outstanding balance at December 31, 2011	509	$	23.32		
Granted	4	$	26.38		
Vesting of Restricted Units	(7)	$	22.53		
Cancelled	(26)	$	19.64		
Outstanding balance at September 30, 2012	480	$	23.56	$	16,013

Restricted Stock Awards

Our executive officers have received grants of restricted stock awards under the 2006 Stock Plan. The vesting of restricted stock awards is subject to the executive officers continued employment with us. Recipients of restricted stock awards are not required to provide us with any consideration other than rendering service. Holders of restricted stock are permitted to vote and to receive dividends.

The stock-based compensation expense for restricted stock awards is determined based on the closing market price of our common stock on the grant date of the awards applied to the total number of awards that are anticipated to fully vest. Upon the vesting of the restricted stock awards, shares withheld to pay taxes are retired. We did not issue restricted stock awards during the nine months ended September 30, 2012. At September 30, 2012 approximately 191,880 shares underlying restricted stock awards remained unvested and there was approximately $1.1 million of unrecognized compensation cost related to restricted stock awards, which is expected to be recognized over the weighted-average period of 0.9 years. Stock-based compensation expense related to restricted stock awards was $0.2 million for each of the three months ended September 30, 2012 and 2011, and $0.6 million for each of the nine months ended September 30, 2012 and 2011.

A summary of the status of our restricted stock awards at September 30, 2012 and of changes in restricted stock awards outstanding under the 2006 Stock Plan for the nine months ended September 30, 2012 is as follows (*in thousands, except for weighted average grant date fair value*):

	Shares		Weighted Average Grant Date Fair Value per Share		Aggregate Intrinsic Value
Outstanding balance at December 31, 2011	288	$	10.42		
Granted					
Vesting of Restricted Awards	(62)	$	10.42		
Shares withheld for payment of taxes upon vesting of restricted stock awards	(34)	$	10.42		
Outstanding balance at September 30, 2012	192	$	10.42	$	6,407

The total fair value of restricted stock awards vested during the nine months ended September 30, 2012 was $1.0 million.

8. Subsequent Events

The Compensation Committee of the Board of Directors approved the October 5, 2012 grant of 929,842 stock option awards and 96,127 restricted stock units to employees and directors. The fair value calculated for stock options and restricted stock units which vest over a range of 1 to 3.25 years was $8.7 million and $2.7 million respectively.

On October 29, 2012, our Board of Directors authorized management to repurchase up to $50.0 million of our common stock from time to time on the open market or in privately negotiated transactions, for a period of up to two years. Repurchased shares will be available for use in connection with our stock plans and for other corporate purposes.

In connection with the preparation of these Consolidated Financial Statements, an evaluation of subsequent events was performed through the date these Consolidated Financial Statements were issued and there are no other events that have occurred that would require adjustments or disclosure to our Consolidated Financial Statements.

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

We begin Management s Discussion and Analysis of Financial Condition and Results of Operations with a discussion of the critical accounting policies that we believe are important to understanding the assumptions and judgments incorporated in our reported financial results. We then present a business overview followed by a discussion of our results of operations. Lastly, we provide an analysis of our liquidity and capital resources, including discussions of our cash flows, sources of capital and financial commitments.

The following discussions and analysis of financial condition and results of operations should be read in conjunction with the other sections of our Annual Report on Form 10-K for the year ended December 31, 2011, including the Consolidated Financial Statements and Supplemental Data thereto appearing in Part II, Item 8 of the Annual Report, the Risk Factors appearing in Part I, Item 1A of the Annual Report and Part II of this 10-Q, and the disclaimer regarding forward-looking statements appearing at the beginning of Part I, Item 1 of the Annual Report. Historical results set forth in Part II, Item 6, Item 7 and Item 8 of the Annual Report should not be taken as necessarily indicative of our future operations.

Critical Accounting Policies

Since the date of our Annual Report on Form 10-K for the year ended December 31, 2011, there have been no material changes to our critical accounting policies.

General Overview

We provide cost containment services to government and private healthcare payers and sponsors. Our services ensure that healthcare claims are paid correctly, through our program integrity services, and by the responsible party, through our coordination of benefits services. Our services help clients recover amounts from liable third parties; prevent future inappropriate payments; reduce fraud, waste and abuse; and ensure regulatory compliance.

Our clients are state Medicaid agencies; the Centers for Medicare & Medicaid Services, or CMS; Medicaid and Medicare managed care plans; government and private employers; Pharmacy Benefit Managers, or PBMs; child support agencies; the Veterans Health Administration, or VHA; commercial health plans; and other healthcare payers.

Since our inception we have grown both organically and through targeted acquisitions. In 1985 we began providing coordination of benefits services to state Medicaid agencies. As Medicaid began to migrate members to managed care, we expanded into the Medicaid managed care market, providing the same coordination of benefits services. We launched our program integrity services in 2007 and have since acquired several businesses: Permedion, Inc., Prudent Rx, and Allied Management Group Special Investigations Unit, Inc., or AMG-SIU, to build out our service offerings. In 2009, we entered the Medicare market with our acquisition of IntegriGuard, LLC, or IntegriGuard, which provides fraud, waste and abuse analytical services to the Medicare program. In 2009 and 2010, we entered the commercial market working with large self-funded employers through our acquisitions of Verify Solutions, Inc. and Chapman Kelly, Inc.

In December 2011, we acquired privately-held HDI Holdings, Inc. and its operating subsidiary, HealthDataInsights, Inc., or HDI. Based in Las Vegas, Nevada, HDI provides improper payment identification services for government and commercial health plans, and is the Medicare Recovery Audit Contractor (RAC) in CMS Region D, covering 17 states and three U.S. territories. HDI offers a comprehensive suite of claims integrity services, including complex medical reviews, automated reviews, hospital bill audits, and pharmacy audits. The acquisition of HDI extends our reach in the federal, state and commercial markets and provides us with an immediate platform to expand service offerings to our existing clients.

In connection with our acquisition of HDI, we entered into a five year, revolving and term secured credit agreement, which we refer to as the Credit Agreement, with certain financial institutions and Citibank, N.A. as Administrative Agent. The Credit Agreement is guaranteed by our material subsidiaries and is supported by a security interest in all or substantially all of our, and our subsidiaries , personal property assets. The Credit Agreement, which matures in December 2016, provides for a term loan of $350.0 million, or the Term Loan, which was used to finance our acquisition of HDI, and a revolving credit facility in an initial amount of $100.0 million. Under specified circumstances, the revolving credit facility can be increased by up to $50.0 million in additional term or revolving loan commitments.

At September 30, 2012, our cash and cash equivalents and net working capital were $128.0 million and $208.4 million, respectively. To date, we have grown our business through the internal development of new products and services, the extension of our products and services into new markets and through acquisitions of businesses whose core services strengthen our overall mission to help our clients control healthcare costs. In addition, we leverage our expertise to acquire new clients at the state, federal and employer levels and to expand our current contracts to provide new services to current clients. Our growth to date has also been driven by an overall increase in Medicaid expenditures and State governments increased use of vendors for the coordination of

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benefits and other cost containment functions. We are continuously evaluating opportunities that will enable us to expand the breadth of the services we provide and will consider acquisition opportunities that enable us to continue to grow our business to address the increasing needs of the healthcare industry.

As of September 30, 2012, we served the District of Columbia and 44 state Medicaid programs, and 148 Medicaid health plans under an aggregate of 70 contracts. We also act as a subcontractor for certain business outsourcing and technology firms.

In September 2012, our wholly owned subsidiary, IntegriGuard, which is doing business as HMS Federal, entered into a contract with CMS to perform the Coordination of Benefits and Medicare Secondary Payer Business Program Operations. The contract has an initial term of one year and may be renewed by CMS for four additional one year periods. We have received a stop work order from CMS that will remain in effect until the Government Accountability Office (GAO) has made a determination with respect to bid protests filed with respect to this award. We now expect a GAO determination by the end of the first quarter of 2013.

In March 2010, the Patient Protection and Affordable Care Act, or the ACA, was signed into law. In early 2012, the US Supreme Court reviewed the constitutionality of the ACA and in its June 2012 decision, the Court addressed two overarching elements of the ACA, including the requirement that States add new categories of beneficiaries to their Medicaid programs or risk losing all their federal Medicaid funding (the Medicaid expansion). While upholding the constitutionality of the ACA, the Supreme Court ruled that the federal government could not condition continued receipt of a State s existing Medicaid funding on its agreement to implement the Medicaid expansion.

The ACA also includes a number of provisions for combating fraud, waste and abuse, and we believe that President Obama s re-election and the strong bipartisan support for containing healthcare costs through the measures identified in the ACA, provides us with platform for continued growth. We plan to develop and build on existing partnerships with states, the federal government, health plans, and partners to provide services that address these provisions and assist clients with their cost containment objectives.

In addition to the information provided below, you should refer to the items disclosed as our Critical Accounting Policies in Part II, Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations of our Annual Report.

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SUMMARY OF OPERATING RESULTS

Three Months Ended September 30, 2012 Compared to Three Months Ended September 30, 2011

The following table sets forth, for the periods indicated, certain items in our consolidated statements of comprehensive income expressed as a percentage of revenue:

	Three months ended September 30,	
	2012	2011
Revenue	100.0%	100.0%
Cost of service		
Compensation	35.5%	34.4%
Data processing	7.0%	6.5%
Occupancy	3.9%	4.1%
Direct project costs	12.8%	10.7%
Other operating costs	2.8%	5.0%
Amortization of intangibles	7.2%	1.8%
Total cost of services	69.2%	62.5%
Selling, general, and administrative expenses	12.5%	11.4%
Total operating expenses	81.7%	73.9%
Operating income	18.3%	26.1%
Interest expense	(3.6)%	0.0%
Other income, net	0%	0.1%
Interest income	0%	0.0%
Income before income taxes	14.7%	26.2%
Income taxes	(5.4)%	(10.6)%
Net income	9.3%	15.6%

Revenue for the three months ended September 30, 2012 was $113.2 million, an increase of $20.8 million, or 22.6%, compared to revenue of $92.4 million in the same quarter for the prior year. Revenue generated by HDI, which we acquired in December 2011, provided $27.9 million of the increase in revenue. Revenue generated by new clients for whom there was no revenue in the prior year period provided $4.2 million of the increase. Fluctuations in existing client accounts, together with changes in the yield and scope of those projects, and differences in the timing of when client projects were completed in the current year compared to the prior year, provided a $9.4 million decrease in revenue. Contract expirations resulted in a revenue decrease of $1.9 million.

Compensation expense as a percentage of revenue was 35.5% for the three months ended September 30, 2012, compared to 34.4% for the three months ended September 30, 2011. Compensation expense for the current quarter was $40.2 million, an $8.4 million, or 26.5%, increase over compensation expense of $31.8 million for the same quarter in the prior year. During the quarter ended September 30, 2012, we averaged 2,274 employees, a 41.4% increase over our average of 1,608 employees during the quarter ended September 30, 2011. This increase reflects the addition of HDI staff in connection with our December 2011 acquisition, and the addition of staff in the areas of client support, technical support and operations.

Data processing expense as a percentage of revenue was 7.0% for the three months ended September 30, 2012, compared to 6.5% for the three months ended September 30, 2011. Data processing expense was $7.9 million for the current quarter, an increase of $1.9 million, or 31.8%, over data processing expense of $6.0 million for the same quarter in the prior year. This increase reflects $1.1 million in additional software related costs and $0.8 million in additional hardware and hosting costs due to the growth of our business, including increases in transaction volume and the number of employees.

Occupancy expense as a percentage of revenue was 3.9% for the three months ended September 30, 2012, compared to 4.1% for the three months ended September 30, 2011. Occupancy expense for the current quarter was $4.4 million, a $0.6 million, or 16.7%, increase compared to occupancy expense of $3.8 million for the same quarter in the prior year. This increase primarily reflects $0.4 million in additional rent and related expense resulting from our acquisition of HDI in December 2011.

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Direct project expense as a percentage of revenue was 12.8% for the three months ended September 30, 2012, compared to 10.7% for the three months ended September 30, 2011. Direct project expense for the current quarter was $14.5 million, a $4.6 million, or 46.9%, increase compared to direct project expense of $9.9 million for the same quarter in the prior year. This increase resulted from a $5.2 million increase primarily related to HDI subcontractor fees, partially offset by a $0.6 million decrease for subcontractor expenses and a $0.2 million decrease for temporary help.

Other operating costs as a percentage of revenue were 2.8% for the three months ended September 30, 2012 compared to 5.0% for the three months ended September 30, 2011. Other operating costs for the current quarter were $3.2 million, a decrease of $1.4 million, or 31.0%, compared to operating costs of $4.6 million for the same quarter in the prior year. This decrease primarily resulted from a $2.3 million decrease due to the reversal of contingent consideration due to the sellers of AMG, partially offset by a $0.6 million increase in professional fees, and a $0.3 million increase primarily related to professional fees incurred by HDI.

Amortization of acquisition-related software and intangibles as a percentage of revenue was 7.2% for the three months ended September 30, 2012, compared to 1.8% for the three months ended September 30, 2011. Amortization of acquisition-related software and intangibles for the current quarter was $8.1 million, compared to amortization expense of $1.7 million for the same quarter in the prior year. The increase in amortization expense of $6.5 million is primarily related to our acquisition of HDI.

Selling, general, and administrative expense as a percentage of revenue was 12.5% for the three months ended September 30, 2012 compared to 11.4% for the three months ended September 30, 2011. Selling, general, and administrative expense for the current quarter was $14.2 million, a $3.6 million, or 34.1%, increase compared to $10.6 million for the same quarter in the prior year. During the quarter ended September 30, 2012, we averaged 218 corporate employees, a 75.8% increase over our average of 124 corporate employees during the quarter ended September 30, 2011. Compensation expense increased by $2.5 million due to the increase in headcount and stock compensation expense. Data processing expense increased by $0.5 million due to higher software and equipment related expenses. Occupancy expenses increased by $0.2 million due to increases in telecommunications and equipment expense.

Operating income for the three months ended September 30, 2012 was $20.7 million, a decrease of $3.4 million, or 14.0%, compared to $24.1 million for the three months ended September 30, 2011.

Interest expense was $4.1 million for the three months ended September 30, 2012 and $19,000 for the three months ended September 30, 2011. Interest expense represents borrowings under our Term Loan, amortization of deferred financing costs, commitment fees for our Credit Agreement and issuance fees for our irrevocable standby letter of credit or Letter of Credit. The increase of $4.1 million compared to the prior year period primarily represents $3.0 million in interest expense on our Term Loan and $0.9 million in related amortization of deferred financing costs. Interest income was $13,000 for the three months ended September 30, 2012, compared to interest income of $14,000 for the three months ended September 30, 2011. Net other income decreased to $27,000 for the quarter ended September 30, 2012 from $165,000 in the prior year period, primarily as a result of a reduction in rental income as leases with tenants in the building we acquired in Irving, Texas expired and were not renewed.

We recorded income tax expense of $6.1 million for the quarter ended September 30, 2012, compared to income tax expense of $9.8 million for the three months ended September 30, 2011, a decrease of $3.7 million. Our effective tax rate decreased to 36.8% for the quarter ended September 30, 2012 from 40.5% for the quarter ended September 30, 2011, primarily due to a change in state apportionments and permanent differences. The principal difference between the statutory rate and our effective rate are state taxes and permanent differences.

Net income of $10.5 million in the current quarter represents a decrease of $3.9 million, or 27.1%, compared to net income of $14.4 million in the same quarter for the prior year.

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Nine Months Ended September 30, 2012 Compared to Nine Months Ended September 30, 2011

The following table sets forth, for the periods indicated, certain items in our consolidated statements of comprehensive income expressed as a percentage of revenue:

	Nine months ended September 30,	
	2012	2011
Revenue	100.0%	100.0%
Cost of service		
Compensation	35.1%	35.8%
Data processing	6.7%	6.3%
Occupancy	3.7%	4.3%
Direct project costs	11.9%	11.5%
Other operating costs	4.2%	5.1%
Amortization of intangibles	7.2%	1.9%
Total cost of services	68.8%	64.9%
Selling, general, and administrative expenses	12.9%	12.1%
Total operating expenses	81.7%	77.0%
Operating income	18.3%	23.0%
Interest expense	(3.6)%	0.0%
Other income, net	0.1%	0.2%
Interest income	0%	0.0%
Income before income taxes	14.8%	23.2%
Income taxes	(5.8)%	(9.3)%
Net income	9.0%	13.9%

Revenue for the nine months ended September 30, 2012 was $340.6 million, an increase of $76.4 million, or 28.9%, compared to revenue of $264.2 million in the same period for the prior year. Revenue generated by HDI, which we acquired in December 2011, provided $75.1 million of the increase in revenue. Revenue generated by new clients for whom there was no revenue in the prior year period provided $8.7 million of the increase. Fluctuations in existing client accounts, together with changes in the yield and scope of those projects, and differences in the timing of when client projects were completed in the current year compared to the prior year, provided a $1.8 million decrease in revenue. Contract expirations resulted in a revenue decrease of $5.6 million.

Compensation expense as a percentage of revenue was 35.1% for the nine months ended September 30, 2012, compared to 35.8% for the nine months ended September 30, 2011. Compensation expense for the current quarter was $119.5 million, a $24.9 million, or 26.3%, increase over compensation expense of $94.6 million for the same quarter in the prior year. During the nine months ended September 30, 2012, we averaged 2,182 employees, a 35.2% increase over our average of 1,614 employees during the nine months ended September 30, 2011. This increase reflects the addition of HDI staff in connection with our December 2011 acquisition, and the addition of staff in the areas of client support, technical support and operations.

Data processing expense as a percentage of revenue was 6.7% for the nine months ended September 30, 2012, compared to 6.3% for the nine months ended September 30, 2011. Data processing expense was $22.8 million for the nine months ended September 30, 2012, an increase of $6.2 million, or 37.2%, over data processing expense of $16.6 million for the same period in the prior year. Revenue growth as well as acquisitions drove the need for increased capacity in our data processing environment. This increase reflects $3.3 million in additional software related costs, $2.1 million in additional hardware and hosting costs, and $0.8 million in additional data communications and data costs due to the growth of our business, including increases in transaction volume and the number of employees.

Occupancy expense as a percentage of revenue was 3.7% for the nine months ended September 30, 2012, compared to 4.3% for the nine months ended September 30, 2011. Occupancy expense for the current period was $12.7 million, a $1.4 million, or 12.5%, increase compared to occupancy expense of $11.3 million for the same period in the prior year. This increase reflects $1.0 million in additional rent and related expense resulting from our acquisition of HDI in December 2011, $0.3 million related to depreciation expense, and $0.1 million related to off-site storage.

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Direct project expense as a percentage of revenue was 11.9% for the nine months ended September 30, 2012, compared to 11.5% for the nine months ended September 30, 2011. Direct project expense for the current period was $40.6 million, a $10.0 million, or 32.8%, increase compared to direct project expense of $30.5 million for the same period in the prior year. This increase resulted from a $10.5 million increase primarily related to HDI subcontractor fees, partially offset by a $0.5 million reduction in software leases, local taxes and printing expenses.

Other operating costs as a percentage of revenue were 4.2% for the nine months ended September 30, 2012 compared to 5.1% for the nine months ended September 30, 2011. Other operating costs for the current period were $14.3 million, an increase of $0.9 million, or 6.4%, compared to operating costs of $13.4 million for the same period in the prior year. This increase primarily resulted from a $2.4 million increase in professional fees, a $1.0 million increase primarily related to professional fees incurred by HDI , a $0.1 million increase in travel expenses and a $0.1 million increase in postage expenses. These increases were partially offset by the reversal of the $2.3 million contingent consideration related to our AMG-SIU acquisition and a related $0.4 million decrease for previously accrued accretion for that contingent consideration**.**

Amortization of acquisition-related software and intangibles as a percentage of revenue was 7.2% for the nine months ended September 30, 2012, compared to 1.9% for the nine months ended September 30, 2011. Amortization of acquisition-related software and intangibles for the current period was $24.4 million, compared to amortization expense of $5.0 million for the same period in the prior year. The increase in amortization expense of $19.4 million is primarily related to our acquisition of HDI.

Selling, general, and administrative expense as a percentage of revenue was 12.9% for the nine months ended September 30, 2012 compared to 12.1% for the nine months ended September 30, 2011. Selling, general, and administrative expense for the current period was $43.9 million, a $12.0 million, or 37.5%, increase compared to $31.9 million for the same period in the prior year. During the period ended September 30, 2012, we averaged 207 corporate employees, a 72.5% increase over our average of 120 corporate employees during the period ended September 30, 2011. Compensation expense increased by $9.5 million due to the increase in headcount and stock compensation. Data processing expense increased by $1.3 million relating to software and equipment expense. Occupancy expenses increased by $0.5 million due to telecommunications expenses and additional space requirements. Other expenses increased by $0.7 million primarily due to an increase in professional fees.

Operating income for the nine months ended September 30, 2012 was $62.4 million, an increase of $1.8 million, or 2.8%, compared to $60.6 million for the nine months ended September 30, 2011.

Interest expense was $12.5 million for the nine months ended September 30, 2012 and $65,000 for the nine months ended September 30, 2011. Interest expense represents borrowings under our Term Loan, amortization of deferred financing costs, commitment fees for our Credit Agreement and issuance fees for our Letter of Credit. The increase of $12.4 million compared to the prior year period primarily represents $9.6 million in interest expense on our Term Loan and $2.8 million in related amortization of deferred financing costs. Interest income was $17,000 for the nine months ended September 30, 2012, compared to interest income of $50,000 for the nine months ended September 30, 2011. Net other income decreased to $346,000 for the nine months ended September 30, 2012 from $714,000 in the prior year period, primarily as a result of a reduction in rental income as leases with tenants in the building we acquired in Irving, Texas expired and were not renewed.

We recorded income tax expense of $19.7 million for the nine months ended September 30, 2012, compared to income tax expense of $24.7 million for the nine months ended September 30, 2011, a decrease of $5.0 million. Our effective tax rate decreased to 39.3% for the nine months ended September 30, 2012 from 40.3% for the nine months ended September 30, 2011, primarily due to a change in state apportionments and permanent differences. The principal difference between the statutory rate and our effective rate are state taxes and permanent differences.

Net income of $30.5 million in the current period represents a decrease of $6.2 million, or 16.7%, compared to net income of $36.7 million in the same period for the prior year.

Contractual Obligations

There have been no material changes in our contractual obligations as presented in our Annual report on Form 10-K for the year ended December 31, 2011.

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Off-Balance Sheet Arrangements

Other than our Letter of Credit, we do not have any off-balance sheet arrangements.

Liquidity and Capital Resources

This data should be read in conjunction with our Consolidated Statements of Cash Flows.

(in thousands)		**September 30, 2012**		**December 31, 2011**
Cash and cash equivalents	$	127,952	$	97,003
Working capital	$	208,359	$	169,862

A summary of our cash flows is as follows:

		Nine months ended		
(in thousands)		**September 30, 2012**		**September 30, 2011**
Net cash provided by operating activities	$	54,920	$	49,090
Net cash used in investing activities	$	(21,702)	$	(19,742)
Net cash (used in)/provided by financing activities	$	(2,269)	$	16,267
Net increase in cash and cash equivalents	$	30,949	$	45,615

We believe that our cash generating capability and financial condition, together with our revolving credit facility will be adequate to meet our operating, investing and financing needs. Our principal source of cash has been our Term Loan and cash flow from operations. The primary uses of cash are compensation expenses, data processing, direct project costs and selling, general and administration expenses. Other sources of cash include proceeds from exercise of stock options and tax benefits associated with stock option exercises. We expect that operating cash flows will continue to be a primary source of liquidity for our operating needs. There are currently no loans outstanding under the revolving credit facility of the Credit Agreement.

We rely on operating cash flows and cash and cash equivalent balances to provide for our liquidity requirements. We believe that we have the ability to obtain both short-term and long-term loans to meet our financing needs for the foreseeable future. Due to our significant operating cash flows, access to capital markets and available term and revolving loans under the Credit Agreement, we continue to believe that we have the ability to meet our liquidity needs for the foreseeable future, which include:

- the working capital requirements of our operations;

- investments in our business;
- business-development activities; and
- repayment of our Term Loan.

Cash Flows from Operating Activities

Net cash provided by operating activities for the nine-month period ended September 30, 2012 was $54.9 million, a $5.8 million increase over net cash provided by operating activities of $49.1 million for the nine-month period ended September 30, 2011. This increase was primarily attributed to amortization of intangibles and capitalized software related to the acquisition of HDI.

Cash Flows from Investing Activities

Net cash used in investing activities for the nine-month period ended September 30, 2012 was $21.7 million, a $2.0 million increase over net cash used in investing activities of $19.7 million for the nine-month period ended September 30, 2011. This increase was primarily attributed to an increase in purchases of property and equipment and an investment made during the period.

Cash Flows from Financing Activities

Net cash used by financing activities for the nine-month period ended September 30, 2012 was $2.3 million, an $18.6 million decrease from net cash provided by financing activities of $16.3 million for the nine-month period ended September 30, 2011. This decrease was primarily attributed to purchases of treasury stock and payments toward the outstanding balance of our term loan.

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The number of days sales outstanding as of September 30, 2012 decreased by ten days to 92 days from 102 days at December 31, 2011.

Operating cash flows could be adversely affected by a decrease in demand for our services or if contracts with our largest clients are cancelled. The majority of our client relationships have been in place for several years, as a result, we do not expect any decrease in the demand for our services in the near term.

Recently Issued Accounting Pronouncements

See Recently Issued Accounting Pronouncements in Note 1 of the Notes to Consolidated Financial Statements.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

At September 30, 2012, we were not a party to any derivative financial instruments. We conduct all of our business in U.S. currency and hence do not have direct foreign currency risk. We are exposed to changes in interest rates, primarily with respect to the Term Loan under the Credit Agreement. If the effective interest rate for all of our variable rate debt were to increase by 100 basis points (1%), our annual interest expense would increase by a maximum of $3.4 million based on our debt balances at September 30, 2012. Further, we currently invest substantially all of our excess cash in short-term investments, primarily money market accounts, where returns effectively reflect current interest rates. As a result, market interest rate changes may impact our interest income or expense. The impact will depend on variables such as the magnitude of rate changes and the level of borrowings or excess cash balances. We do not consider this risk to be material. We manage such risk by continuing to evaluate the best investment rates available for short-term, high quality investments.

Item 4. Controls and Procedures

We maintain disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934 or the Exchange Act) that are designed to ensure that information required to be disclosed by us in reports that we file under the Exchange Act is recorded, processed, summarized and reported as specified in the SEC s rules and forms, and that such information required to be disclosed by us in reports that we file under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and our Chief Financial Officer, to allow timely decisions regarding required disclosure.

As required by Rule 13a-15(b) under the Exchange Act, management, with the participation of our Chief Executive Officer and Chief Financial Officer, performed an evaluation of the effectiveness of our disclosure controls and procedures as of September 30, 2012. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this quarterly report.

We acquired HDI on December 16, 2011 and are in the process of integrating HDI into our internal controls over financial reporting structure. As a result, there have been changes to our internal controls over financial reporting during the nine months ended September 30, 2012 that are associated with our establishment and implementation of internal control over financial reporting with respect to HDI.

With the exception of the above changes related to our integration of HDI, there were no changes in our internal control over financial reporting during the nine months ended September 30, 2012 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II OTHER INFORMATION

Item 1A. Risk Factors

Risks that could have a negative impact on our business, results of operations and financial condition include without limitation: (i) regulatory actions, budgetary pressures and political influences that could affect the procurement practices and operations of healthcare organizations and agencies, reducing demand for our services; (ii) our ability to continue to secure new contracts and contract renewals through the competitive bidding process and any related protests and to accurately predict the cost and time to complete such contracts; (iii) our ability to retain clients or the loss of one or more major clients; (iv) client dissatisfaction or early termination of contracts triggering significant costs or liabilities; (v) the development by competitors of new or superior products or services; (vi) the emergence of new competitors, or the development by our clients of in-house capacity to perform the services we offer; (vii) all the risks inherent in the development, introduction, and implementation of new products and services; (viii) our ability to manage our growth and its demands on our resources and infrastructure; (ix) our ability to successfully integrate our acquisitions; (x) our compliance with the covenants and obligations under the terms of our credit facility and our ability to generate sufficient cash

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to cover our interest and principal payments thereunder; (xi) variations in our results of operations; (xii) negative results of government reviews, audits or investigations to verify our compliance with contracts and applicable laws and regulations; (xiii) changing conditions in the healthcare industry which could simplify the payment process and reduce the need for and price of our services; (xiv) our failure to comply with laws and regulations governing health data or to protect such data from theft and misuse; and, (xv) our ability to maintain effective information systems and protect them from damage or interruption. A more detailed description of each of these and other risk factors can be found under the caption Risk Factors in our most recent Annual Report on Form 10-K, filed with the SEC on February 29, 2012.

The risks described in our Annual Report on Form 10-K, as updated by our quarterly reports on Form 10-Q, are not the only risks facing our Company. Additional risks and uncertainties not currently known to us, or that we currently deem to be immaterial, may also materially adversely affect our business, financial condition and/or operating results.

Item 5. Other Information

Sean Curtin, our Executive Vice President and Chief Operations Officer, will be resigning from this position effective December 31, 2012. Mr. Curtin will remain an employee of the Company through February 2013 to assist with the transition of his responsibilities.

Item 6. Exhibits

The exhibits filed as part of this Quarterly Report on Form 10-Q are listed on the Exhibit Index immediately following the Signatures.

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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.

Date:	November 9, 2012	**HMS HOLDINGS CORP.**	
		By:	/s/ William C. Lucia William C. Lucia President and Chief Executive Officer and Duly Authorized Officer (Principal Executive Officer)
		By:	/s/ Walter D. Hosp Walter D. Hosp Chief Financial Officer and Duly Authorized Officer (Principal Financial Officer)

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Exhibit Index

Exhibit No.	Description
10.1	Agreement to Extend Terms of Previous Agreements, dated September 27, 2012, by and between Health Management Systems, Inc. and Public Consulting Group, Inc.
10.2	Agreement to Extend Terms of Previous Agreements, dated November 7, 2012, by and between Health Management Systems, Inc. and Public Consulting Group, Inc.
31.1	Rule 13a-14(a)/15d-14(a) Certification of the Principal Executive Officer of HMS Holdings Corp., as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Rule 13a-14(a)/15d-14(a) Certification of the Principal Financial Officer of HMS Holdings Corp., as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Section 1350 Certification of the Principal Executive Officer of HMS Holdings Corp., as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Section 1350 Certification of the Principal Financial Officer of HMS Holdings Corp., as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

Furnished herewith