HCA INC/TN
Form 10-Q
May 14, 2009

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**
**Washington, D.C. 20549**

# Form 10-Q

(Mark One)

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

**For the quarterly period ended March 31, 2009**

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 1-11239**

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

| | |
|---|---|
| **Delaware** | **75-2497104** |
| *(State or other jurisdiction of incorporation or organization)* | *(I.R.S. Employer Identification No.)* |
| **One Park Plaza Nashville, Tennessee** | **37203** |
| *(Address of principal executive offices)* | *(Zip Code)* |

**(615) 344-9551**
*(Registrant s telephone number, including area code)*

**Not Applicable**
*(Former name, former address and former fiscal year, if changed since last report)*

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 þ 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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes o No o

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 o | Accelerated filer o | Non-accelerated filer þ (Do not check if a smaller reporting company) | 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 þ

Indicate the number of shares outstanding of each of the issuer s classes of common stock of the latest practicable date.

| **Class of Common Stock** | **Outstanding at April 30, 2009** |
|---|---|
| Voting common stock, $.01 par value | 94,383,900 shares |

**HCA INC.**

**Form 10-Q**
**March 31, 2009**

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**HCA INC.**
**CONDENSED CONSOLIDATED INCOME STATEMENTS**
**FOR THE QUARTERS ENDED MARCH 31, 2009 AND 2008**
**Unaudited**
**(Dollars in millions)**

| | 2009 | 2008 |
|---|---|---|
| Revenues | **$ 7,431** | $ 7,127 |
| Salaries and benefits | **2,923** | 2,839 |
| Supplies | **1,210** | 1,173 |
| Other operating expenses | **1,102** | 1,114 |
| Provision for doubtful accounts | **807** | 888 |
| Equity in earnings of affiliates | **(68)** | (67) |
| Depreciation and amortization | **353** | 357 |
| Interest expense | **471** | 530 |
| Losses (gains) on sales of facilities | **5** | (51) |
| Impairment on long-lived assets | **9** | |
| | **6,812** | 6,783 |
| Income before income taxes | **619** | 344 |
| Provision for income taxes | **187** | 119 |
| Net income | **432** | 225 |
| Net income attributable to noncontrolling interests | **72** | 55 |
| Net income attributable to HCA Inc. | **$ 360** | $ 170 |

See accompanying notes.

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**HCA INC.**
**CONDENSED CONSOLIDATED BALANCE SHEETS**
**Unaudited**
**(Dollars in millions)**

| | March 31, 2009 | December 31, 2008 |
|---|---|---|
| **ASSETS** | | |
| Current assets: | | |
| Cash and cash equivalents | **$ 356** | $ 465 |
| Accounts receivable, less allowance for doubtful accounts of $5,594 and $5,435 | **3,870** | 3,780 |
| Inventories | **717** | 737 |
| Deferred income taxes | **988** | 914 |
| Other | **558** | 405 |
| | **6,489** | 6,301 |
| Property and equipment, at cost | **23,913** | 23,714 |
| Accumulated depreciation | **(12,458)** | (12,185) |
| | **11,455** | 11,529 |
| Investments of insurance subsidiary | **1,302** | 1,422 |
| Investments in and advances to affiliates | **860** | 842 |
| Goodwill | **2,579** | 2,580 |
| Deferred loan costs | **452** | 458 |
| Other | **1,147** | 1,148 |
| | **$ 24,284** | $ 24,280 |
| **LIABILITIES AND STOCKHOLDERS DEFICIT** | | |
| Current liabilities: | | |
| Accounts payable | **$ 1,200** | $ 1,370 |
| Accrued salaries | **823** | 854 |
| Other accrued expenses | **1,458** | 1,282 |
| Long-term debt due within one year | **416** | 404 |
| | **3,897** | 3,910 |
| Long-term debt | **26,151** | 26,585 |
| Professional liability risks | **1,098** | 1,108 |
| Income taxes and other liabilities | **1,853** | 1,782 |
| Equity securities with contingent redemption rights | **154** | 155 |
| Stockholders deficit: | | |

| | | |
|---|---|---|
| Common stock $.01 par; authorized 125,000,000 shares; outstanding 94,378,600 shares in 2009 and 94,367,500 shares in 2008 | **1** | 1 |
| Capital in excess of par value | **176** | 165 |
| Accumulated other comprehensive loss | **(608)** | (604) |
| Retained deficit | **(9,457)** | (9,817) |
| Stockholders deficit attributable to HCA Inc. | **(9,888)** | (10,255) |
| Noncontrolling interests | **1,019** | 995 |
| | **(8,869)** | (9,260) |
| | **$ 24,284** | $ 24,280 |

See accompanying notes.

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# HCA INC.
## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
## FOR THE QUARTERS ENDED MARCH 31, 2009 AND 2008
### Unaudited
### (Dollars in millions)

| | 2009 | 2008 |
|---|---|---|
| Cash flows from operating activities: | | |
| Net income | **$ 432** | $ 225 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Changes in operating assets and liabilities | **(1,111)** | (1,183) |
| Provision for doubtful accounts | **807** | 888 |
| Depreciation and amortization | **353** | 357 |
| Income taxes | **41** | (9) |
| Losses (gains) on sales of facilities | **5** | (51) |
| Impairment of long-lived assets | **9** | |
| Change in noncontrolling interests | **(48)** | (49) |
| Amortization of deferred loan costs | **21** | 23 |
| Pay-in-kind interest | **39** | |
| Share-based compensation | **7** | 7 |
| Other | **12** | 19 |
| Net cash provided by operating activities | **567** | 227 |
| Cash flows from investing activities: | | |
| Purchase of property and equipment | **(337)** | (308) |
| Acquisition of hospitals and health care entities | **(38)** | (24) |
| Disposition of hospitals and health care entities | **5** | 107 |
| Change in investments | **76** | (11) |
| Other | **6** | 9 |
| Net cash used in investing activities | **(288)** | (227) |
| Cash flows from financing activities: | | |
| Issuance of long-term debt | **300** | 4 |
| Net change in revolving bank credit facility | **(335)** | 650 |
| Repayment of long-term debt | **(339)** | (575) |
| Other | **(14)** | (1) |
| Net cash (used in) provided by financing activities | **(388)** | 78 |
| Change in cash and cash equivalents | **(109)** | 78 |
| Cash and cash equivalents at beginning of period | **465** | 393 |
| Cash and cash equivalents at end of period | **$ 356** | $ 471 |
| Interest payments | **$ 344** | $ 411 |

| | | |
|---|---|---|
| Income tax payments, net | **$ 146** | $ 127 |

See accompanying notes.

**HCA INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**
**Unaudited**

## NOTE 1 INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

*Merger, Recapitalization and Reporting Entity*

On November 17, 2006, HCA Inc. completed its merger (the Merger ) with Hercules Acquisition Corporation, pursuant to which the Company was acquired by Hercules Holding II, LLC ( Hercules Holding ), a Delaware limited liability company owned by a private investor group comprised of affiliates of Bain Capital Partners ( Bain ), Kohlberg Kravis Roberts & Co. ( KKR ), Merrill Lynch Global Private Equity ( MLGPE ) (each a Sponsor ) and of Citigroup Inc. and Bank of America Corporation (the Sponsor Assignees ), by affiliates of HCA founder, Dr. Thomas F. Frist Jr., (the Frist Entities, and together with the Sponsors and the Sponsor Assignees, the Investors ), and by members of management and certain other investors. The Merger, the financing transactions related to the Merger and other related transactions are collectively referred to in this quarterly report as the Recapitalization. The Merger was accounted for as a recapitalization in our financial statements, with no adjustments to the historical basis of our assets and liabilities. As a result of the Recapitalization, our outstanding capital stock is owned by the Investors, certain members of management and key employees and certain other investors. On April 29, 2008, we registered our common stock pursuant to Section 12(g) of the Securities Exchange Act of 1934, as amended, thus subjecting us to the reporting requirements of Section 13(a) of the Securities Exchange Act of 1934, as amended. Our common stock is not traded on a national securities exchange.

*Basis of Presentation*

HCA Inc. is a holding company whose affiliates own and operate hospitals and related health care entities. The term affiliates includes direct and indirect subsidiaries of HCA Inc. and partnerships and joint ventures in which such subsidiaries are partners. At March 31, 2009, these affiliates owned and operated 155 hospitals, 97 freestanding surgery centers and facilities which provided extensive outpatient and ancillary services. Affiliates of HCA are also partners in joint ventures that own and operate eight hospitals and eight freestanding surgery centers which are accounted for using the equity method. The Company s facilities are located in 20 states and England. The terms HCA, Company, we, our or us, as used in this quarterly report on Form 10-Q, refer to HCA Inc. and its affiliates unless otherwise stated or indicated by context.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles 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 the information and footnotes required by generally accepted accounting principles for complete consolidated financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation have been included and are of a normal and recurring nature. In accordance with Financial Accounting Standards No. 160, Noncontrolling Interests in Consolidated Financial Statements-an Amendment of ARB No. 51, references in this report to our net income attributable to HCA Inc. and stockholders deficit attributable to HCA Inc. do not include noncontrolling interests (previously known as minority interests), which we now report separately. The majority of our expenses are cost of revenue items. Costs that could be classified as general and administrative would include our corporate office costs, which were $37 million and $40 million for the quarters ended March 31, 2009 and 2008, respectively. Operating results for the quarter ended March 31, 2009 are not necessarily indicative of the results that may be expected for the year ending December 31, 2009. For further information, refer to the consolidated financial statements and footnotes thereto included in our annual report on Form 10-K for the year ended December 31, 2008.

Certain prior year amounts have been reclassified to conform to the current year presentation.

**NOTE 2 INCOME TAXES**

We are currently contesting before the Appeals Division of the Internal Revenue Service ( IRS ), certain claimed deficiencies and adjustments proposed by the IRS in connection with its examination of the 2003 and 2004

**HCA INC.**

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

**NOTE 2 INCOME TAXES (continued)**

federal income tax returns for HCA and 14 affiliates that are treated as partnerships for federal income tax purposes ( affiliated partnerships ). The disputed items include the timing of recognition of certain patient service revenues and our method for calculating the tax allowance for doubtful accounts.

Eight taxable periods of HCA and its predecessors ended in 1995 through 2002 and the 2002 taxable year for 10 affiliated partnerships, for which the primary remaining issue is the computation of the tax allowance for doubtful accounts, are pending before the IRS Examination Division or the United States Tax Court as of March 31, 2009. The IRS began an audit of the 2005 and 2006 federal income tax returns for HCA and seven affiliated partnerships during 2008.

Our liability for unrecognized tax benefits was $614 million, including accrued interest of $166 million, as of March 31, 2009 ($625 million and $156 million, respectively, as of December 31, 2008). Unrecognized tax benefits of $263 million ($264 million as of December 31, 2008) would affect the effective rate, if recognized. The liability for unrecognized tax benefits does not reflect deferred tax assets related to deductible interest and state income taxes or the balance of a refundable deposit we made in 2006, which is recorded in noncurrent assets. The provision for income taxes reflects a $20 million reduction in interest expense and interest expense of $12 million related to taxing authority examinations for the quarters ended March 31, 2009 and March 31, 2008, respectively.

Depending on the resolution of the IRS disputes, the completion of examinations by federal, state or international taxing authorities, or the expiration of statutes of limitation for specific taxing jurisdictions, we believe it is reasonably possible our liability for unrecognized tax benefits may significantly increase or decrease within the next 12 months. However, we are currently unable to estimate the range of any possible change.

**NOTE 3 INVESTMENTS OF INSURANCE SUBSIDIARY**

A summary of our insurance subsidiary s investments at March 31, 2009 and December 31, 2008 follows (dollars in millions):

| | March 31, 2009 | | | |
|---|---|---|---|---|
| | | Unrealized Amounts | | |
| | Amortized Cost | Gains | Losses | Fair Value |
| Debt securities: | | | | |
| States and municipalities | $ 789 | $ 24 | $ (16) | $ 797 |
| Auction rate securities | 574 | | (42) | 532 |
| Asset-backed securities | 49 | | (4) | 45 |
| Money market funds | 122 | | | 122 |
| | 1,534 | 24 | (62) | 1,496 |

| | | | | |
|---|---|---|---|---|
| Equity securities: | | | | |
| Preferred stocks | 6 | | (3) | 3 |
| Common stocks | 3 | | | 3 |
| | 9 | | (3) | 6 |
| | $ 1,543 | $ 24 | $ (65) | 1,502 |
| Amount classified as current assets | | | | (200) |
| Investment carrying value | | | | $ 1,302 |

**HCA INC.**

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

**NOTE 3 INVESTMENTS OF INSURANCE SUBSIDIARY (continued)**

| | December 31, 2008 | | | |
|---|---|---|---|---|
| | Amortized Cost | Unrealized Amounts Gains | Unrealized Amounts Losses | Fair Value |
| Debt securities: | | | | |
| States and municipalities | $ 808 | $ 20 | $ (23) | $ 805 |
| Auction rate securities | 576 | | (40) | 536 |
| Asset-backed securities | 51 | 1 | (5) | 47 |
| Money market funds | 226 | | | 226 |
| | 1,661 | 21 | (68) | 1,614 |
| Equity securities: | | | | |
| Preferred stocks | 6 | | (1) | 5 |
| Common stocks | 3 | | | 3 |
| | 9 | | (1) | 8 |
| | $ 1,670 | $ 21 | $ (69) | 1,622 |
| Amount classified as current assets | | | | (200) |
| Investment carrying value | | | | $ 1,422 |

At March 31, 2009 and December 31, 2008, the investments of our insurance subsidiary were classified as available-for-sale. Changes in temporary unrealized gains and losses are recorded as adjustments to other comprehensive income. At March 31, 2009 and December 31, 2008, $106 million and $119 million, respectively, of our investments were subject to restrictions included in insurance bond collateralization and assumed reinsurance contracts.

**HCA INC.**

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

## NOTE 4 LONG-TERM DEBT

A summary of long-term debt at March 31, 2009 and December 31, 2008, including related interest rates at March 31, 2009, follows (dollars in millions):

| | March 31, 2009 | December 31, 2008 |
|---|---|---|
| Senior secured asset-based revolving credit facility (effective interest rate of 2.0%) | **$ 1,715** | $ 2,000 |
| Senior secured revolving credit facility | | 50 |
| Senior secured term loan facilities (effective interest rate of 6.0%) | **11,641** | 12,002 |
| Other senior secured debt (effective interest rate of 6.9%) | **385** | 406 |
| First lien debt | **13,741** | 14,458 |
| Senior secured cash-pay notes (effective interest rate of 9.7%) | **4,500** | 4,200 |
| Senior secured toggle notes (effective interest rate of 10.0%) | **1,500** | 1,500 |
| Second lien debt | **6,000** | 5,700 |
| Senior unsecured notes payable through 2095 (effective interest rate of 7.2%) | **6,826** | 6,831 |
| Total debt (average life of six years, rates averaging 6.9%) | **26,567** | 26,989 |
| Less amounts due within one year | **416** | 404 |
| | **$ 26,151** | $ 26,585 |

During February 2009, we issued $310 million aggregate principal amount of 97/8% senior secured notes due 2017 at a price of 96.673% of their face value, resulting in approximately $300 million of gross proceeds. We used the proceeds to repay outstanding indebtedness under our senior secured term loan facilities.

During April 2009, we issued $1.500 billion aggregate principal amount of 81/2% senior secured notes due 2019 at a price of 96.755% of their face value, resulting in approximately $1.451 billion of gross proceeds. We used the proceeds to repay outstanding indebtedness under our senior secured term loan facilities.

## NOTE 5 FINANCIAL INSTRUMENTS

*Interest Rate Swap Agreements*

We have entered into interest rate swap agreements to manage our exposure to fluctuations in interest rates. These swap agreements involve the exchange of fixed and variable rate interest payments between two parties based on common notional principal amounts and maturity dates. Pay-fixed interest rate swaps effectively convert LIBOR indexed variable rate instruments to fixed interest rate obligations. The net interest payments, based on the notional amounts in these agreements, generally match the timing of the related liabilities. The notional amounts of the swap agreements represent amounts used to calculate the exchange of cash flows and are not our assets or liabilities. Our credit risk related to these agreements is considered low because the swap agreements are with creditworthy financial institutions. The interest payments under these agreements are settled on a net basis.

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**HCA INC.**

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

**NOTE 5 FINANCIAL INSTRUMENTS (continued)**

*Interest Rate Swap Agreements (continued)*

The following table sets forth our interest rate swap agreements, which have been designated as cash flow hedges, at March 31, 2009 (dollars in millions):

| | Notional Amount | Termination Date | Fair Value |
|---|---|---|---|
| Pay-fixed interest rate swap | $ 4,000 | November 2011 | $ (328) |
| Pay-fixed interest rate swap | 4,000 | November 2011 | (309) |
| Pay-fixed interest rate swap | 500 | March 2011 | (15) |
| Pay-fixed interest rate swap | 500 | March 2011 | (15) |

During the next 12 months, we estimate that $318 million will be reclassified from other comprehensive income ( OCI ) to interest expense.

*Cross Currency Swaps*

The Company and certain subsidiaries have incurred obligations and entered into various intercompany transactions where such obligations are denominated in currencies (Great Britain Pound and Euro), other than the functional currencies (United States Dollar and Great Britain Pound) of the parties executing the trade. In order to mitigate the currency exposure risks and better match the cash flows of our obligations and intercompany transactions with cash flows from operations, we entered into various cross currency swaps. Our credit risk related to these agreements is considered low because the swap agreements are with creditworthy financial institutions.

Certain of our cross currency swaps were not designated as hedges, and changes in fair value are recognized in results of operations. The following table sets forth these cross currency swap agreements at March 31, 2009 (amounts in millions):

| | Notional Amount | Termination Date | Fair Value |
|---|---|---|---|
| Euro United States Dollar currency swap | 541 Euro | December 2011 | $ 40 |
| Euro Great Britain Pound (GBP) currency swap | 30 Euro | December 2011 | 14 |

The following table sets forth our cross currency swap agreements, which have been designated as cash flow hedges, at March 31, 2009 (amounts in millions):

| | | Notional Amount | Termination Date | Fair Value |
|---|---|---|---|---|
| GBP | United States Dollar currency swap | 50 GBP | November 2010 | $ (16) |
| GBP | United States Dollar currency swap | 50 GBP | November 2010 | (15) |

**HCA INC.**

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

**NOTE 5 FINANCIAL INSTRUMENTS (continued)**

*Cross Currency Swaps (continued)*

*Derivatives Results of Operations*

The following tables present the effect on our results of operations for our interest rate and cross currency swaps for the quarter ended March 31, 2009 (amounts in millions):

| Derivatives in Cash Flow Hedging Relationships | Amount of Loss Recognized in OCI on Derivatives, Net of Tax | Location of Loss Reclassified from Accumulated OCI into Operations | Amount of Loss Reclassified from Accumulated OCI into Operations |
|---|---|---|---|
| Interest rate swaps | $ 51 | Interest expense | $ 72 |
| Cross currency swaps | 3 | Interest expense | |
| | $ 54 | | $ 72 |

| Derivatives Not Designated as Hedging Instruments | Location of Loss Recognized in Operations on Derivatives | Amount of Loss Recognized in Operations on Derivatives |
|---|---|---|
| Cross currency swaps | Other operating expense | $ 43 |

*Credit-risk-related Contingent Features*

We have agreements with each of our derivative counterparties that contain a provision where we could be declared in default on our derivative obligations if repayment of the underlying indebtedness is accelerated by the lender due to our default on the indebtedness. As of March 31, 2009, we have not been required to post any collateral related to these agreements. If we had breached any of these provisions at March 31, 2009, we would have been required to settle our obligations under the agreements at their aggregate, estimated termination value of $725 million.

**NOTE 6 ASSETS AND LIABILITIES MEASURED AT FAIR VALUE**

On January 1, 2008, we adopted Statement of Financial Accounting Standards No. 157, Fair Value Measurements ( SFAS 157 ). SFAS 157 defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. SFAS 157 applies to reported balances that are required or permitted to be measured at fair value under existing accounting pronouncements.

SFAS 157 emphasizes that fair value is a market-based measurement, not an entity-specific measurement. Therefore, a fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability. As a basis for considering market participant assumptions in fair value measurements, SFAS 157 establishes a fair value hierarchy that distinguishes between market participant assumptions based on market data obtained from sources independent of the reporting entity (observable inputs that are classified within Levels 1 and 2 of the hierarchy) and the reporting entity s own assumptions about market participant assumptions (unobservable inputs classified within Level 3 of the hierarchy).

Level 1 inputs utilize quoted prices (unadjusted) in active markets for identical assets or liabilities. Level 2 inputs are inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. Level 2 inputs may include quoted prices for similar assets and liabilities in active markets, as well as inputs that are observable for the asset or liability (other than quoted prices), such as interest rates, foreign exchange rates, and yield curves that are observable at commonly quoted intervals. Level 3 inputs are unobservable inputs for the asset or liability, which are typically based on an entity s own assumptions, as there is little, if any, related market activity. In instances where the determination of the fair value measurement is based on inputs from different levels of the fair value hierarchy, the level in the fair value hierarchy within which the entire fair value

## HCA INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## NOTE 6 ASSETS AND LIABILITIES MEASURED AT FAIR VALUE (continued)

measurement falls is based on the lowest level input that is significant to the fair value measurement in its entirety. Our assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment, and considers factors specific to the asset or liability.

*Cash Traded Investments*

Our cash traded investments are generally classified within Level 1 or Level 2 of the fair value hierarchy because they are valued using quoted market prices, broker or dealer quotations, or alternative pricing sources with reasonable levels of price transparency. Certain types of cash traded instruments are classified within Level 3 of the fair value hierarchy because they trade infrequently and therefore have little or no price transparency. Such instruments include auction rate securities ( ARS ) and limited partnership investments. The transaction price is initially used as the best estimate of fair value.

Our wholly-owned insurance subsidiary had investments in municipal, tax-exempt ARS, that are backed by student loans substantially guaranteed by the federal government, of $532 million ($572 million par value) at March 31, 2009. We do not currently intend to attempt to sell the ARS as the liquidity needs of our insurance subsidiary are expected to be met by other investments in its investment portfolio. These securities continue to accrue and pay interest semi-annually based on the failed auction maximum rate formulas stated in their respective Official Statements. During 2008 and the first quarter of 2009, certain issuers of our ARS redeemed $94 million of our securities at par value. The valuation of these securities involved management s judgment, after consideration of market factors and the absence of market transparency, market liquidity and observable inputs. Our valuation models derived a fair market value compared to tax-equivalent yields of other student loan backed variable rate securities of similar credit worthiness.

*Derivative Financial Instruments*

We have entered into interest rate and cross currency swap agreements to manage our exposure to fluctuations in interest rates and foreign currency risks. The valuation of these instruments is determined using widely accepted valuation techniques, including discounted cash flow analysis on the expected cash flows of each derivative. This analysis reflects the contractual terms of the derivatives, including the period to maturity, and uses observable market-based inputs, including interest rate curves, foreign exchange rates and implied volatilities. To comply with the provisions of SFAS 157, we incorporate credit valuation adjustments to reflect both our own nonperformance risk and the respective counterparty s nonperformance risk in the fair value measurements.

Although we have determined that the majority of the inputs used to value our derivatives fall within Level 2 of the fair value hierarchy, the credit valuation adjustments associated with our derivatives utilize Level 3 inputs, such as estimates of current credit spreads to evaluate the likelihood of default by us and our counterparties. We have assessed the significance of the impact of the credit valuation adjustments on the overall valuation of our derivative positions and have determined that the credit valuation adjustments are significant to the overall valuation of our derivatives. As a result, we have determined that our derivative valuations in their entirety are classified in Level 3 of the fair value hierarchy at March 31, 2009.

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**HCA INC.**

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

**NOTE 6 ASSETS AND LIABILITIES MEASURED AT FAIR VALUE (continued)**

The following table summarizes our assets and liabilities measured at fair value on a recurring basis as of March 31, 2009, aggregated by the level in the fair value hierarchy within which those measurements fall (dollars in millions):

| | | Fair Value Measurements Using | | |
|---|---|---|---|---|
| | Fair Value | Quoted Prices in Active Markets for Identical Assets and Liabilities (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Assets: | | | | |
| Investments of insurance subsidiary | $ 1,502 | $ 123 | $ 845 | $ 534 |
| Less amounts classified as current assets | (200) | (122) | (78) | |
| | 1,302 | 1 | 767 | 534 |
| Cross currency swaps (Other assets) | 54 | | | 54 |
| Liabilities: | | | | |
| Interest rate swaps (Income taxes and other liabilities) | 667 | | | 667 |
| Cross currency swaps (Income taxes and other liabilities) | 31 | | | 31 |

The following table summarizes the activity related to the investments of our insurance subsidiary and our cross currency and interest rate swaps which have fair value measurements based on significant unobservable inputs (Level 3) during the quarter ended March 31, 2009 (dollars in millions):

| | Investments of Insurance Subsidiary | Cross Currency Swaps (net) | Interest Rate Swaps |
|---|---|---|---|
| Asset (liability) balances at December 31, 2008 | $ 538 | $ 71 | $ (657) |
| Realized gains and losses included in earnings | | (43) | 72 |
| Unrealized gains and losses included in other comprehensive income | (2) | (5) | (82) |

| | | | | | | |
|---|---|---|---|---|---|---|
| Purchases, issuances and settlements | | (2) | | | | |
| Asset (liability) balances at March 31, 2009 | $ | 534 | $ | 23 | $ | (667) |

**NOTE 7 CONTINGENCIES**

We operate in a highly regulated and litigious industry. As a result, various lawsuits, claims and legal and regulatory proceedings have been and can be expected to be instituted or asserted against us. The resolution of any such lawsuits, claims or legal and regulatory proceedings could have a material, adverse effect on our results of operations or financial position in a given period.

We are subject to claims and suits arising in the ordinary course of business, including claims for personal injuries or wrongful restriction of, or interference with, physicians staff privileges. In certain of these actions the claimants may seek punitive damages against us which may not be covered by insurance. It is management s opinion that the ultimate resolution of these pending claims and legal proceedings will not have a material, adverse effect on our results of operations or financial position.

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**HCA INC.**

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

## NOTE 8 COMPREHENSIVE INCOME AND CAPITAL STRUCTURE

The components of comprehensive income, net of related taxes, for the quarters ended March 31, 2009 and 2008 are only attributable to HCA Inc. and are as follows (dollars in millions):

| | Quarter 2009 | Quarter 2008 |
|---|---|---|
| Net income attributable to HCA Inc. | **$ 360** | $ 170 |
| Change in fair value of derivative instruments | **(8)** | (167) |
| Change in fair value of available-for-sale securities | **4** | (3) |
| Foreign currency translation adjustments | **(2)** | |
| Defined benefit plans | **2** | 1 |
| Comprehensive income | **$ 356** | $ 1 |

The components of accumulated other comprehensive loss, net of related taxes, are as follows (dollars in millions):

| | March 31, 2009 | December 31, 2008 |
|---|---|---|
| Change in fair value of derivative instruments | **$ (448)** | $ (440) |
| Change in fair value of available-for-sale securities | **(26)** | (30) |
| Foreign currency translation adjustments | **(30)** | (28) |
| Defined benefit plans | **(104)** | (106) |
| Accumulated other comprehensive loss | **$ (608)** | $ (604) |

The changes in stockholders deficit, including changes in stockholders deficit attributable to HCA Inc. and changes in equity attributable to noncontrolling interests are as follows (dollars in millions):

| Equity Attributable to HCA Inc. | | | | | | |
|---|---|---|---|---|---|---|
| Common Stock Shares (000) | Common Stock Par Value | Capital in Excess of Par Value | Accumulated Other Comprehensive Loss | Retained Deficit | Equity Attributable to Noncontrolling Interests | Total |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Balances, December 31, 2008 | 94,367 | $ 1 | $ 165 | $ (604) | $ (9,817) | $ 995 | $ (9,260) |
| Net income | | | | | 360 | 72 | 432 |
| Other comprehensive loss | | | | (4) | | | (4) |
| Distributions | | | | | | (48) | (48) |
| Share-based benefit plans | 12 | | 7 | | | | 7 |
| Other | | | 4 | | | | 4 |
| Balances, March 31, 2009 | 94,379 | $ 1 | $ 176 | $ (608) | $ (9,457) | $ 1,019 | $ (8,869) |

**NOTE 9 SEGMENT AND GEOGRAPHIC INFORMATION**

We operate in one line of business, which is operating hospitals and related health care entities. During the quarters ended March 31, 2009 and 2008, approximately 24% of our patient revenues related to patients participating in the fee-for-service Medicare program.

Our operations are structured into three geographically organized groups: the Eastern Group includes 48 consolidating hospitals located in the Eastern United States, the Central Group includes 47 consolidating hospitals located in the Central United States and the Western Group includes 54 consolidating hospitals located in the

**HCA INC.**

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

**NOTE 9 SEGMENT AND GEOGRAPHIC INFORMATION (continued)**

Western United States. We also operate six consolidating hospitals in England, and these facilities are included in the Corporate and other group.

Adjusted segment EBITDA is defined as income before depreciation and amortization, interest expense, losses (gains) on sales of facilities, impairment of long-lived assets, income taxes and noncontrolling interests. We use adjusted segment EBITDA as an analytical indicator for purposes of allocating resources to geographic areas and assessing their performance. Adjusted segment EBITDA is commonly used as an analytical indicator within the health care industry, and also serves as a measure of leverage capacity and debt service ability. Adjusted segment EBITDA should not be considered as a measure of financial performance under generally accepted accounting principles, and the items excluded from adjusted segment EBITDA are significant components in understanding and assessing financial performance. Because adjusted segment EBITDA is not a measurement determined in accordance with generally accepted accounting principles and is thus susceptible to varying calculations, adjusted segment EBITDA, as presented, may not be comparable to other similarly titled measures of other companies. The geographic distributions of our revenues, equity in earnings of affiliates, adjusted segment EBITDA and depreciation and amortization are summarized in the following table (dollars in millions):

| | Quarter | |
|---|---|---|
| | **2009** | **2008** |
| Revenues: | | |
| Central Group | **$ 1,803** | $ 1,692 |
| Eastern Group | **2,275** | 2,220 |
| Western Group | **3,151** | 2,975 |
| Corporate and other | **202** | 240 |
| | **$ 7,431** | $ 7,127 |
| Equity in earnings of affiliates: | | |
| Central Group | **$ (1)** | $ (1) |
| Eastern Group | | (1) |
| Western Group | **(67)** | (66) |
| Corporate and other | | 1 |
| | **$ (68)** | $ (67) |
| Adjusted segment EBITDA: | | |
| Central Group | **$ 351** | $ 296 |
| Eastern Group | **433** | 354 |
| Western Group | **733** | 570 |
| Corporate and other | **(60)** | (40) |

| | | |
|---|---|---|
| | **$ 1,457** | $ 1,180 |
| Depreciation and amortization: | | |
| Central Group | **$ 88** | $ 91 |
| Eastern Group | **90** | 90 |
| Western Group | **144** | 138 |
| Corporate and other | **31** | 38 |
| | **$ 353** | $ 357 |

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**HCA INC.**

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

**NOTE 9 SEGMENT AND GEOGRAPHIC INFORMATION (continued)**

| | Quarter | |
|---|---|---|
| | **2009** | **2008** |
| Adjusted segment EBITDA | **$ 1,457** | $ 1,180 |
| Depreciation and amortization | **353** | 357 |
| Interest expense | **471** | 530 |
| Losses (gains) on sales of facilities | **5** | (51) |
| Impairment of long-lived assets | **9** | |
| Income before income taxes | **$ 619** | $ 344 |

**NOTE 10 ACQUISITIONS, DISPOSITIONS AND IMPAIRMENT OF LONG-LIVED ASSETS**

During the quarter ended March 31, 2009, we paid $38 million to acquire other health care entities. During the quarter ended March 31, 2008, we paid $18 million to acquire one hospital and $6 million to acquire other health care entities.

During the quarter ended March 31, 2009, we received proceeds of $5 million and recognized a net pretax loss of $5 million related to the sales of hospital facilities and other investments. During the quarter ended March 31, 2008, we received proceeds of $107 million and recognized a net pretax gain of $51 related primarily to the sale of a hospital facility.

During the quarter ended March 31, 2009, we recorded a charge of $9 million to adjust the value of certain real estate investments in our Central Group to estimated fair value. There were no impairments of long-lived assets in the quarter ended March 31, 2008.

## HCA INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## NOTE 11 SUPPLEMENTAL CONDENSED CONSOLIDATING FINANCIAL INFORMATION

Our senior secured credit facilities and senior secured notes are fully and unconditionally guaranteed by substantially all existing and future, direct and indirect, wholly-owned material domestic subsidiaries that are Unrestricted Subsidiaries under our Indenture dated December 16, 1993 (except for certain special purpose subsidiaries that only guarantee and pledge their assets under our senior secured asset-based revolving credit facility).

Our summarized condensed consolidating balance sheets at March 31, 2009 and December 31, 2008 and condensed consolidating statements of income and cash flows for the quarters ended March 31, 2009 and 2008, segregating the parent company issuer, the subsidiary guarantors, the subsidiary non-guarantors and eliminations, follow.

**HCA INC.**
**CONDENSED CONSOLIDATING INCOME STATEMENT**
**FOR THE QUARTER ENDED MARCH 31, 2009**
**(Dollars in millions)**

| | Parent Issuer | Subsidiary Guarantors | Subsidiary Non-Guarantors | Eliminations | Condensed Consolidated |
|---|---|---|---|---|---|
| Revenues | $ | $ 4,393 | $ 3,038 | $ | $ 7,431 |
| Salaries and benefits | | 1,755 | 1,168 | | 2,923 |
| Supplies | | 721 | 489 | | 1,210 |
| Other operating expenses | 5 | 617 | 480 | | 1,102 |
| Provision for doubtful accounts | | 508 | 299 | | 807 |
| Equity in earnings of affiliates | (705) | (24) | (44) | 705 | (68) |
| Depreciation and amortization | | 196 | 157 | | 353 |
| Interest expense | 542 | (66) | (5) | | 471 |
| Losses (gains) on sales of facilities | | 7 | (2) | | 5 |
| Impairment of long-lived assets | | 9 | | | 9 |
| Management fees | | (116) | 116 | | |
| | (158) | 3,607 | 2,658 | 705 | 6,812 |
| Income (loss) before income taxes | 158 | 786 | 380 | (705) | 619 |
| Provision for income taxes | (202) | 270 | 119 | | 187 |
| Net income (loss) | 360 | 516 | 261 | (705) | 432 |
| Net income attributable to noncontrolling interests | | 14 | 58 | | 72 |
| | $ 360 | $ 502 | $ 203 | $ (705) | $ 360 |

Net income (loss) attributable to HCA Inc.

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**HCA INC.**

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

**NOTE 11 SUPPLEMENTAL CONDENSED CONSOLIDATING FINANCIAL INFORMATION (continued)**

**HCA INC.**
**CONDENSED CONSOLIDATING INCOME STATEMENT**
**FOR THE QUARTER ENDED MARCH 31, 2008**
**(Dollars in millions)**

| | Parent Issuer | Subsidiary Guarantors | Subsidiary Non-Guarantors | Eliminations | Condensed Consolidated |
|---|---|---|---|---|---|
| Revenues | $ | $ 4,159 | $ 2,968 | $ | $ 7,127 |
| Salaries and benefits | | 1,709 | 1,130 | | 2,839 |
| Supplies | | 679 | 494 | | 1,173 |
| Other operating expenses | 6 | 589 | 519 | | 1,114 |
| Provision for doubtful accounts | | 556 | 332 | | 888 |
| Equity in earnings of affiliates | (525) | (26) | (41) | 525 | (67) |
| Depreciation and amortization | | 196 | 161 | | 357 |
| Interest expense | 558 | (7) | (21) | | 530 |
| Gains on sales of facilities | | (2) | (49) | | (51) |
| Management fees | | (113) | 113 | | |
| | 39 | 3,581 | 2,638 | 525 | 6,783 |
| Income (loss) before income taxes | (39) | 578 | 330 | (525) | 344 |
| Provision for income taxes | (209) | 220 | 108 | | 119 |
| Net income (loss) | 170 | 358 | 222 | (525) | 225 |
| Net income attributable to noncontrolling interests | | 12 | 43 | | 55 |
| Net income (loss) attributable to HCA Inc. | $ 170 | $ 346 | $ 179 | $ (525) | $ 170 |

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# HCA INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## NOTE 11 SUPPLEMENTAL CONDENSED CONSOLIDATING FINANCIAL INFORMATION (continued)

### HCA INC.
### CONDENSED CONSOLIDATING BALANCE SHEET
### MARCH 31, 2009
### (Dollars in millions)

| | Parent Issuer | Subsidiary Guarantors | Subsidiary Non-Guarantors | Eliminations | Condensed Consolidated |
|---|---|---|---|---|---|
| **ASSETS** | | | | | |
| Current assets: | | | | | |
| Cash and cash equivalents | $ | $ 126 | $ 230 | $ | $ 356 |
| Accounts receivable, net | | 2,282 | 1,588 | | 3,870 |
| Inventories | | 436 | 281 | | 717 |
| Deferred income taxes | 988 | | | | 988 |
| Other | | 174 | 384 | | 558 |
| | 988 | 3,018 | 2,483 | | 6,489 |
| Property and equipment, net | | 7,079 | 4,376 | | 11,455 |
| Investments of insurance subsidiary | | | 1,302 | | 1,302 |
| Investments in and advances to affiliates | | 246 | 614 | | 860 |
| Goodwill | | 1,642 | 937 | | 2,579 |
| Deferred loan costs | 452 | | | | 452 |
| Investments in and advances to subsidiaries | 19,995 | | | (19,995) | |
| Other | 1,014 | 28 | 105 | | 1,147 |
| | $ 22,449 | $ 12,013 | $ 9,817 | $ (19,995) | $ 24,284 |
| **LIABILITIES AND STOCKHOLDERS (DEFICIT) EQUITY** | | | | | |
| Current liabilities: | | | | | |
| Accounts payable | $ | $ 741 | $ 459 | $ | $ 1,200 |
| Accrued salaries | | 522 | 301 | | 823 |
| Other accrued expenses | 623 | 269 | 566 | | 1,458 |
| Long-term debt due within one year | 386 | | 30 | | 416 |

| | | | | | |
|---|---|---|---|---|---|
| | 1,009 | 1,532 | 1,356 | | 3,897 |
| Long-term debt | 25,677 | 101 | 373 | | 26,151 |
| Intercompany balances | 4,173 | (8,439) | 4,266 | | |
| Professional liability risks | | | 1,098 | | 1,098 |
| Income taxes and other liabilities | 1,324 | 398 | 131 | | 1,853 |
| | 32,183 | (6,408) | 7,224 | | 32,999 |
| Equity securities with contingent redemption rights | 154 | | | | 154 |
| Stockholders (deficit) equity attributable to HCA Inc. | (9,888) | 18,290 | 1,705 | (19,995) | (9,888) |
| Noncontrolling interests | | 131 | 888 | | 1,019 |
| | (9,888) | 18,421 | 2,593 | (19,995) | (8,869) |
| | $ 22,449 | $ 12,013 | $ 9,817 | $ (19,995) | $ 24,284 |

**HCA INC.**

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

**NOTE 11 SUPPLEMENTAL CONDENSED CONSOLIDATING FINANCIAL INFORMATION (continued)**

**HCA INC.**
**CONDENSED CONSOLIDATING BALANCE SHEET**
**DECEMBER 31, 2008**
**(Dollars in millions)**

| | Parent Issuer | Subsidiary Guarantors | Subsidiary Non-Guarantors | Eliminations | Condensed Consolidated |
|---|---|---|---|---|---|
| **ASSETS** | | | | | |
| Current assets: | | | | | |
| Cash and cash equivalents | $ | $ 134 | $ 331 | $ | $ 465 |
| Accounts receivable, net | | 2,214 | 1,566 | | 3,780 |
| Inventories | | 455 | 282 | | 737 |
| Deferred income taxes | 914 | | | | 914 |
| Other | | 140 | 265 | | 405 |
| | 914 | 2,943 | 2,444 | | 6,301 |
| Property and equipment, net | | 7,122 | 4,407 | | 11,529 |
| Investments of insurance subsidiary | | | 1,422 | | 1,422 |
| Investments in and advances to affiliates | | 243 | 599 | | 842 |
| Goodwill | | 1,643 | 937 | | 2,580 |
| Deferred loan costs | 458 | | | | 458 |
| Investments in and advances to subsidiaries | 19,290 | | | (19,290) | |
| Other | 1,050 | 31 | 67 | | 1,148 |
| | $ 21,712 | $ 11,982 | $ 9,876 | $ (19,290) | $ 24,280 |
| **LIABILITIES AND STOCKHOLDERS (DEFICIT) EQUITY** | | | | | |
| Current liabilities: | | | | | |
| Accounts payable | $ | $ 881 | $ 489 | $ | $ 1,370 |
| Accrued salaries | | 549 | 305 | | 854 |
| Other accrued expenses | 435 | 284 | 563 | | 1,282 |
| Long-term debt due within one year | 355 | | 49 | | 404 |
| | 790 | 1,714 | 1,406 | | 3,910 |
| Long-term debt | 26,089 | 99 | 397 | | 26,585 |

| | | | | | |
|---|---|---|---|---|---|
| Intercompany balances | 3,663 | (8,136) | 4,473 | | |
| Professional liability risks | | | 1,108 | | 1,108 |
| Income taxes and other liabilities | 1,270 | 379 | 133 | | 1,782 |
| | 31,812 | (5,944) | 7,517 | | 33,385 |
| Equity securities with contingent redemption rights | 155 | | | | 155 |
| Stockholders (deficit) equity attributable to HCA Inc. | (10,255) | 17,788 | 1,502 | (19,290) | (10,255) |
| Noncontrolling interests | | 138 | 857 | | 995 |
| | (10,255) | 17,926 | 2,359 | (19,290) | (9,260) |
| | $ 21,712 | $ 11,982 | $ 9,876 | $ (19,290) | $ 24,280 |

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**HCA INC.**

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

**NOTE 11 SUPPLEMENTAL CONDENSED CONSOLIDATING FINANCIAL INFORMATION (continued)**

**HCA INC.**
**CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS**
**FOR THE QUARTER ENDED MARCH 31, 2009**
**(Dollars in millions)**

| | Parent Issuer | Subsidiary Guarantors | Subsidiary Non-Guarantors | Eliminations | Condensed Consolidated |
|---|---|---|---|---|---|
| **Cash flows from operating activities:** | | | | | |
| Net income | $ 360 | $ 516 | $ 261 | $ (705) | $ 432 |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: | | | | | |
| Increase (decrease) in cash from operating assets and liabilities | 75 | (706) | (480) | | (1,111) |
| Provision for doubtful accounts | | 508 | 299 | | 807 |
| Depreciation and amortization | | 196 | 157 | | 353 |
| Income taxes | 41 | | | | 41 |
| Losses on sales of facilities | | 1 | 4 | | 5 |
| Impairments of long-lived assets | | 9 | | | 9 |
| Change in noncontrolling interests | | (21) | (27) | | (48) |
| Amortization of deferred loan costs | 21 | | | | 21 |
| Pay-in-kind interest | 39 | | | | 39 |
| Share-based compensation | 7 | | | | 7 |
| Equity in earnings of affiliates | (705) | | | 705 | |
| Other | 4 | 12 | (4) | | 12 |
| Net cash provided by (used in) operating activities | (158) | 515 | 210 | | 567 |
| **Cash flows from investing activities:** | | | | | |
| Purchase of property and equipment | | (177) | (160) | | (337) |
| Acquisition of hospitals and health care entities | | (38) | | | (38) |
| Disposition of hospitals and health care entities | | 1 | 4 | | 5 |
| Change in investments | | (4) | 80 | | 76 |
| Other | | | 6 | | 6 |

| | | | | | |
|---|---|---|---|---|---|
| Net cash used in investing activities | | (218) | (70) | | (288) |
| **Cash flows from financing activities:** | | | | | |
| Issuance of long-term debt | 300 | | | | 300 |
| Net change in revolving bank credit facility | (335) | | | | (335) |
| Repayment of long-term debt | (285) | (1) | (53) | | (339) |
| Changes in intercompany balances with affiliates, net | 492 | (304) | (188) | | |
| Other | (14) | | | | (14) |
| Net cash provided by (used in) financing activities | 158 | (305) | (241) | | (388) |
| Change in cash and cash equivalents | | (8) | (101) | | (109) |
| Cash and cash equivalents at beginning of period | | 134 | 331 | | 465 |
| Cash and cash equivalents at end of period | $ | $ 126 | $ 230 | $ | $ 356 |

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**HCA INC.**

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

**NOTE 11 SUPPLEMENTAL CONDENSED CONSOLIDATING FINANCIAL INFORMATION (continued)**

**HCA INC.**
**CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS**
**FOR THE QUARTER ENDED MARCH 31, 2008**
**(Dollars in millions)**

| | Parent Issuer | Subsidiary Guarantors | Subsidiary Non-Guarantors | Eliminations | Condensed Consolidated |
|---|---|---|---|---|---|
| **Cash flows from operating activities:** | | | | | |
| Net income | $ 170 | $ 358 | $ 222 | $ (525) | $ 225 |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: | | | | | |
| Increase (decrease) in cash from operating assets and liabilities | 102 | (984) | (301) | | (1,183) |
| Provision for doubtful accounts | | 556 | 332 | | 888 |
| Depreciation and amortization | | 196 | 161 | | 357 |
| | 62,857,309 | 61,375,333 | | | |
| Basic EPS | $ 0.00 | $ 0.01 | $ (0.00 ) | $ 0.01 | |
| Diluted EPS | | | | | |
| Net income | $ 184,808 | $ 412,682 | $ (132,552 ) | $ 651,980 | |
| Weighted average number of common shares | 62,916,422 | 61,375,333 | 62,857,309 | 61,375,333 | |

| | | | | |
|---|---|---|---|---|
| Incremental shares from assumed conversions of stock Options | 1,226,285 | 1,923,822 | - | 1,788,491 |
| Adjusted weighted average number of common shares | 64,142,707 | 63,299,155 | 62,857,309 | 63,163,824 |
| Diluted EPS | $ 0.00 | $ 0.01 | $ (0.00 ) | $ 0.01 |

9. Segment reporting

Segments are defined by authoritative guidance as components of a company in which separate financial information is available and is evaluated by the chief operating decision maker, or a decision making group, in deciding how to allocate resources and in assessing performance. Management evaluates segment performance primarily based on revenue and segment operating income.

The Company operates as three segments, which include Wireless Mobility Management, Cyber Security Solutions, and IT Consulting Services and Products.

Segment operating income consists of the revenues generated by a segment, less the direct costs of revenue and selling, general and administrative costs that are incurred directly by the segment. Unallocated corporate costs include costs related to administrative functions that are performed in a centralized manner that are not attributable to a particular segment. These administrative function costs include costs for corporate office support, all office facility costs, costs relating to accounting and finance, human resources, legal, marketing, information technology and company-wide business development functions, as well as costs related to overall corporate management.

The following tables set forth selected segment and consolidated operating results and other operating data for the periods indicated. Management does not analyze assets for decision making purposes as it relates to the segments below. Accordingly, information is not available for long-lived assets or total assets.

Three Months Ended June 30, 2011

| | Wireless | Cyber | Consulting | Corp | Consol |
|---|---|---|---|---|---|
| Revenue | $6,158,197 | $2,294,973 | $1,512,708 | - | $9,965,878 |
| Operating income including amortization and depreciation expense | 570,994 | 495,652 | (71,159) | (611,858) | 383,629 |
| Interest income (expense), net | | | | (16,823) | (16,823) |
| Pretax income | | | | | 366,806 |
| Income tax benefit | | | | (152,375) | (152,375) |
| Net income | | | | | $214,431 |

Three Months Ended June 30, 2010

| | Wireless | Cyber | Consulting | Corp | Consol |
|---|---|---|---|---|---|
| Revenue | $6,885,987 | $2,486,820 | $3,079,313 | - | $12,452,120 |
| Operating income including amortization and depreciation expense | 567,288 | 596,061 | 54,803 | (706,853) | 511,299 |
| Interest income (expense), net | | | | (20,562) | (20,562) |
| Pretax income | | | | | 490,737 |
| Income tax benefit | | | | (78,055) | (78,055) |
| Net income | | | | | $412,682 |

Six Months Ended June 30, 2011

| | Wireless | Cyber | Consulting | Corp | Consol |
|---|---|---|---|---|---|
| Revenue | $11,765,783 | $3,551,222 | $5,177,998 | - | $20,495,003 |
| Operating income including amortization and depreciation expense | 925,404 | 572,937 | (394,373) | (1,225,287) | (121,299) |
| Interest income (expense), net | | | | (33,186) | (33,186) |
| Other income (expense), net | | | | 1,143 | 1,143 |
| Pretax income | | | | - | (153,342) |
| Income tax benefit | | | | 50,413 | 50,413 |
| Net loss | | | | | $(102,929) |

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Six Months Ended June 30, 2010

| | Wireless | Cyber | Consulting | Corp | Consol |
|---|---|---|---|---|---|
| Revenue | $13,805,799 | $3,912,327 | $5,897,050 | - | $23,615,176 |
| Operating income including amortization and depreciation expense | 1,246,532 | 881,427 | 162,217 | (1,479,594) | 810,582 |
| Interest income (expense), net | | | | (41,325) | (41,325) |
| Pretax income | | | | | 769,257 |
| Income tax expense | | | | (117,277) | (117,277) |
| Net income | | | | | $651,980 |

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

"Forward-Looking" Information

The following discussion and analysis of the financial condition and results of operations of the Company should be read in conjunction with the financial statements and the notes thereto which appear elsewhere in this Quarterly Report on Form 10-Q and the Company's Annual Report on Form 10-K for the year ended December 31, 2010.

The information set forth below contains statements that the Company believes to be "forward-looking statements" within the meaning of the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements include, without limitation, any statement that is not a statement of historical fact, including, without limitation, statements regarding the Company's business strategy and plans and objectives of management for future operations or that may predict, forecast, indicate or imply future results, performance or achievements. The words "estimate," "project," "intend," "forecast," "anticipate," "plan," "planning," "expect," "believe, likely," "should," "could," "would," "may" or the negative of such words or words or expressions of similar meaning ar intended to identify forward-looking statements. These forward-looking statements are not guarantees of future performance, and all such forward-looking statements involve risks and uncertainties, many of which are beyond the Company's ability to control. Actual results may differ materially from those expressed or implied by such forward-looking statements as a result of various factors. All forward-looking statements and other information in this Quarterly Report on Form 10-Q speak only as of the date of this report. We do not undertake, and we disclaim, any obligation to update any forward-looking statements or to announce revisions to any of the forward-looking statements. Certain factors that could cause results to differ materially from those projected in the forward-looking statements are set forth below. Readers are cautioned not to put undue reliance on forward-looking statements. The Company disclaims any intent or obligation to update publicly these forward-looking statements, whether as a result of new information, future events or otherwise.

Business Overview

WidePoint Corporation is a technology-based provider of products and services to both the government sector and commercial markets. WidePoint was incorporated in Delaware on May 30, 1997. We have grown through the merger with and acquisition of highly specialized regional IT consulting companies. Our staff consists of business process and computer specialists who help our government and civilian customers augment and expand their resident technologic skills and competencies, drive technical innovation, and help develop and maintain a competitive edge in today's rapidly changing technological environment in business. Our organization emphasizes an intense commitment to our people, our customers, and the quality of our solutions offerings. As a services organization, our customers are our primary focus.

Our expertise lies in the following three business segments: Wireless Mobility Management; Cyber Security Solutions; and Consulting Services and Products. These business segments offer unique solutions in wireless mobility, cyber security and other associated IT consulting services and products in which we provide specific subject matter expertise in IT architecture and planning, software implementation services, IT outsourcing, and forensic informatics. For additional information related to our three business segments, see Note 9 to our consolidated financial statements in this Quarterly Report on Form 10-Q.

WidePoint has six operational entities, including one development stage entity, which specialize in providing the following products and services:

- ORC specializes in cyber security solutions with a focus on IT integration and secure authentication processes and software, and providing services to the federal government. ORC has been at the forefront of implementing Public Key Infrastructure (PKI) technologies. PKI technology uses a class of algorithms in which a user can receive two electronic keys, consisting of a public key and a private key, to encrypt any information and/or communication being transmitted to or from the user within a computer network and between different computer networks. We believe PKI technology has emerged as the technology of choice to enable security services within and between different computer systems utilized by various agencies and departments of the federal government.

- iSYS specializes in wireless mobility solutions, characterized by comprehensive wireless environment managed services contracts to a number of large US federal agencies. It also specializes in forensic informatics, and Identity Assurance development services, predominantly to various agencies and departments of the federal government.

- WidePoint IL (in conjunction with WP NBIL) specializes in IT consulting services predominantly in the Midwestern regional area and cross-sells various services of our other operating subsidiaries.

- ARCC specializes in providing identity assurance and priority resource management solutions, crime scene management and information protection, and other activities related thereto; and the development, maintenance, enhancement and provision of software, services, products and operations for identity management and information protection, which are offered primarily to state and local government agency markets.

- Protexx, which is a development stage company, specializes in identity assurance, and encrypted mobile and wireless data-in motion protection products and services.

We rely upon a large portion of our revenues from the federal government directly, or as a subcontractor. Our revenues and operating results may vary significantly from quarter-to-quarter, due to revenues earned on contracts, the number of billable days in a quarter, the timing of the pass-through of other direct costs, the commencement and completion of contracts during any particular quarter, the schedule of the government agencies for awarding contracts, the term of each contract that we have been awarded and general economic conditions. Because a significant portion of our expenses, such as personnel and facilities costs, are fixed in the short term, successful contract performance and variation in the volume of activity as well as in the number of contracts commenced or completed during any quarter may cause significant variations in operating results from quarter to quarter.

The federal government's fiscal year ends September 30th. If a budget for the next fiscal year has not been approved by that date, our clients may have to suspend engagements that we are working on until a budget has been approved. Such suspensions may cause us to realize lower revenues in the fourth calendar quarter (i.e., the first quarter of the government's fiscal year). Also, Congressional Budget "Continuing Resolutions", which provide for funding of Federal Agencies at prior year spending levels may impact new awards and cause us to realize lower revenues until such time as the Federal Budget process for the fiscal period has been completed. The federal government's 2010 – 2011 budget was enacted in April 2011. During the first quarter of 2011, the federal government operated under multiple continuing resolutions for budget purposes. While our federal government clients did not have to suspend payments to the Company for the three months ending March 31, 2011, we did witness a substantial slowdown in contract awards and potential new orders as a result of delays associated with funding tied to the various continuing resolutions. Furthermore, the United States Federal Government on August 2, 2011 was required to increase its "debt ceiling" to continue to pay its obligations. As an indirect result of this debt ceiling increase, the United States Congress enacted future budget reducing legislation that may impact spending levels within government agencies that may affect the Company's short term revenue building opportunities.

Further, a change in senior government officials may negatively affect the rate at which the federal government purchases the services that we offer. As a result of the factors above, period-to-period comparisons of our revenues and operating results may not be meaningful. These comparisons are not indicators of future performance and no assurances can be given that quarterly results will not fluctuate, causing a possible material adverse effect on our operating results and financial condition.

Most of WidePoint's current costs consist primarily of the salaries and benefits paid to WidePoint's technical, marketing and administrative personnel as well as vendor-related costs in connection with our Wireless Mobility Management segment. As a result of our plan to expand WidePoint's operations through a combination of internal growth initiatives and merger and acquisition opportunities, WidePoint expects such costs to increase. WidePoint's profitability also depends upon both the volume of services performed and the Company's ability to manage costs. As a significant portion of the Company's cost is labor related, WidePoint must effectively manage these costs to achieve and grow its profitability. The Company must also manage our telephony airtime plans and other vendor related offerings under our Wireless Mobility Management segment provided to our customers as they also represent a significant portion of our costs. To date, the Company has attempted to maximize its operating margins through efficiencies achieved by the use of its proprietary methodologies, and by offsetting increases in consultant salaries with increases in consultant fees received from its clients. The uncertainties relating to the ability to achieve and maintain profitability, obtain additional funding to partially fund the Company's growth strategy and provide the necessary investment to continue to upgrade its management reporting systems to meet the continuing demands of the present regulatory changes affect the comparability of the information reflected in the financial information presented above.

Results of Operations

Three Months Ended June 30, 2011 as Compared to Three Months Ended June 30, 2010

Revenues, net. Revenues for the three month period ended June 30, 2011, were approximately $10.0 million as compared to approximately $12.5 million for the three month period ended June 30, 2010. The decrease in revenues was primarily attributable to decreases in revenues in each of our operating segments as described below:

§ Our Wireless Mobility Management segment recorded revenue of approximately $6.2 million for the quarter ended June 30, 2011 versus approximately $6.9 million for the quarter ended June 30, 2010. This 10.6% reduction in revenue was predominantly the result of a reduction in billable calling minutes and billable services provided to Washington Headquarter Services ("WHS") that was not fully offset by increases in work attributable to new contract awards that we started in the first quarter of 2011. Short-term, we may witness a reduction or variability in revenue growth as the revenue mix in this segment experiences a reduction of billable calling minutes as compared to managed fees as we shift our attention to expanding the fee portion of our sales mix. We are presently pursuing several significant service contract award opportunities at a number of federal agencies and are also initiating a new strategy to expand into state and local municipalities and commercial enterprises by utilizing intermediary sales channels to potentially expand our reach beyond the federal sector and help to support the long-term growth of this segment. The recent budget delays and Federal Government debt ceiling debates have resulted in some contract awards or projects being delayed. We anticipate further growth in the third quarter of 2011 as we continue to add new clients to our current roster of customers. As we continue to market our services we also anticipate we will continue to add units under management from new agency awards along with the possibility of additional awards from states, local municipalities, and other commercial opportunities.

§ Our Cyber Security Solutions segment recorded revenue of approximately $2.3 million for the three month period ended June 30, 2011 versus approximately $2.5 million for the three month period ended June 30, 2010. This 7.7% decrease in revenue was primarily a result of revenues that were delayed as a result of the delivery of work moving from the second quarter of 2011 into the third quarter of 2011, and more importantly, with the delay of anticipated awards in the contract finalization process associated with the delays attributable to the U.S. Budget and Federal debt ceiling debate referred to earlier. We anticipate that this segment should demonstrate revenue growth in the future as various federal agency mandates continue to be implemented in order to strengthen the requirements for greater levels of identity assurance and to better protect the federal information technology infrastructure within federal agencies. We have entered into a number of strategic alliances with partners that facilitates access to various federal agencies and their related technology infrastructures in order to take advantage of these identity management improvement mandates. We believe these new partnerships should widen our sales reach in the future.

§ Our IT Consulting Services and Products segment recorded revenue of approximately $1.5 million for the three month period ended June 30, 2011 versus $3.1 million for the three month period ended June 30, 2010. This 50.9% decrease was materially due to a decrease in our Federal Government related consulting and reselling activities in the second quarter of 2011. We anticipate long-term that this segment should grow at a moderate rate but given the nature and variability of the products and services we offer within this segment, performance and the continuity of growth may prove erratic from period to period.

Cost of sales. Cost of sales for the three month period ended June 30, 2011, was approximately $7.3 million (or 73% of revenues), as compared to cost of sales of approximately $9.5 million (or 76% of revenues) for the three month period ended June 30, 2010. This decrease in cost of sales was primarily attributable to a higher percentage revenue mix in cyber security-based services which tends to provide higher margins as well as a lower percentage mix of consulting services revenues which tend to provide lower margins. We anticipate improvements in our costs of sales as our Cyber Security Solutions segment adds economies of scale and expands in relation to our Consulting Services and Products segment. At times, the fluctuation in our Consulting Services and Products segment revenue mix may cause variability in our cost of sales.

Gross profit. Gross profit for the three month period ended June 30, 2011 was approximately $2.7 million (or 27% of revenues), as compared to gross profit of approximately $2.9 million (or 24% of revenues) for the three month period ended June 30, 2010. The percentage of gross profit was higher in the second quarter as result of higher margins associated with a higher mix in revenues from of our Cyber Security Solutions segment which tends to have higher margins and a lower mix of consulting services revenues which tend to have lower margins. We anticipate gross profit as a percentage of revenues to increase as cost of sales as a percentage of revenues decreases due to a greater mix of higher margin services. We believe as revenues expand in the future there will be periods of variability in margin growth associated with changes in our segments revenue mix.

Sales and marketing. Sales and marketing expense for the three month period ended June 30, 2011, was approximately $385,000 (or 4% of revenues), as compared to approximately $488,000 (or 4% of revenues) for the three month period ended June 30, 2010. The absolute dollar amount of sales and marketing decreased as we optimized and aligned our bid and proposal and marketing efforts. We believe that with our niche capabilities and our selective investment in sales and marketing will support our ability to expand our revenues.

General and administrative. General and administrative expenses for the three month period ended June 30, 2011, were approximately $1.9 million (or 19% of revenues), as compared to approximately $1.9 million (or 15% of revenues) for the three month period ended June 30, 2010. The slight increase in general and administrative expenses over those for the three months ended June 30, 2010, was primarily attributable to increases in non-recurring administrative legal expenses. We believe that our general and administrative costs on a percentage of revenue basis will level out or decrease in future financial reporting periods.

Depreciation. Depreciation expense for the three month period ended June 30, 2011, was approximately $59,000, as compared to approximately $49,000 or the three month period ended June 30, 2010. The increase in depreciation expense was primarily attributable to an increased pool of depreciable assets. We do not anticipate any material changes within depreciation expense in the short-term. However, within our Wireless Mobility Management and Cyber Security Solutions segments, there may be a need from time to time to increase the purchase of equipment in support of new revenue streams that may then raise our depreciation expenses.

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Interest income. Interest income for the three month period ended June 30, 2011, was approximately $3,000, as compared to approximately $2,000, for the three month period ended June 30, 2010. This decrease in interest income for the three month period ended June 30, 2011, was primarily attributable to lesser amountsof invested cash and cash equivalents combined with lower short-term interest rates that were available to the Company on investments in interest bearing accounts. We do not anticipate any material changes in trends in our interest income for the near-term as a result of continuing low short-term interest rates presently payable by financial institutions.

Interest expense. Interest expense for the three month period ended June 30, 2011, was approximately $19,000, as compared to approximately $23,000 for the three month period ended June 30, 2010. This decrease in interest expense for the three month period ended June 30, 2011, was primarily attributable to lesser expenses associated with the debt held by the Company. We anticipate our interest expense will continue to decrease as the Company continues to pay down the principal on its term note held by Cardinal Bank.

Income taxes. Income tax expense for the three month period ended June 30, 2011 was approximately $152,000, as compared to an income tax expense of approximately $78,000 for the three month period ended June 30, 2010. The income tax expense incurred in the second quarter of 2011 was partially the result of the reduction in the income tax benefit realized in the first quarter of 2011. In the fourth quarter of fiscal year 2010, the Company analyzed its ability to utilize net operating losses recorded as deferred tax assets and based on this analysis determined that it was more likely than not that the Company would be able to utilize a substantial portion of its federal net operating losses in future periods and recognized a benefit which continued through the three months ended June 30, 2011. The Company incurred a deferred income tax expense of approximately $39,000 for the three month period ended June 30, 2010, as a result of the recognition of a deferred tax liability attributable to the differences in our treatment of the amortization of goodwill for tax purposes versus book purposes as it relates to our acquisition of iSYS in January 2008.

Net income. As a result of the factors above, the net income for the three month period ended June 30, 2011 was approximately $214,000 as compared to the net income of approximately $413,000 for the three month period ended June 30, 2010.

Six Months Ended June 30, 2011 as Compared to Six Months Ended June 30, 2010

Revenues, net. Revenues for the six month period ended June 30, 2011 were approximately $20.5 million as compared to approximately $23.6 million for the three month period ended June 30, 2010. The decrease in revenues was primarily attributable to decreases as described below in revenue in each of our operating segments:

§ Our Wireless Mobility Management segment experienced decreased revenue of approximately 14.8% to approximately $11.8 million for the six months ended June 30, 2011 from approximately $13.8 million for the six months ended June 30, 2010. The decreased revenue performance was predominately the result of a reduction in billable calling minutes and billable services provided to WHS that was not fully offset by increases in work attributable to new contract awards that we started in the first half of 2011. Short-term we may witness a reduction or variability in revenue growth as the revenue mix in this segment experiences a reduction of billable calling minutes as compared to managed fees as we shift our attention to expanding the fee portion of our sales mix. We are presently pursuing several significant service contract award opportunities at a number of federal agencies and are also initiating a strategy to expand into state and local municipalities and commercial enterprises by utilizing intermediary supply channels to potentially expand our reach beyond the federal sector and help to support the long-term growth of this segment.

§ Our Cyber Security Solutions segment experienced decreased revenue of approximately 9.2% to approximately $3.6 million for the six month period ended June 30, 2011 from approximately $3.9 million for the six month period ended June 30, 2010. This decrease was primarily a result of delays in contract awards associated with Federal Government budget delays and continuing resolutions, which we witnessed during the first half of 2011. We have entered into a number of affiliations with partners who support the end user base, which facilitate access to these various federal agencies and the related technology infrastructure in order to take advantage of these identity management improvement mandates. We believe these new partnerships should widen our sales reach, which we anticipate should support the long-term growth of this segment.

§ Our IT Consulting Services and Products segment experienced decreased revenue of approximately 12.2% to approximately $5.2 million during the six month period ended June 30, 2011 from approximately $5.9 million for the six month period ended June 30, 2010. This decreased revenue performance primarily resulted from delays in contract awards associated with Federal Government budget delays and continuing resolutions, which we witnessed during the first half of 2011. We anticipate that this segment should realize modest growth but given the nature and variability of the products and services we offer within this segment, the growth may be volatile from period to period.

Cost of sales. Cost of sales for the six month period ended June 30, 2011 was approximately $16.0 million (or 78% of revenues), as compared to cost of sales of approximately $18.2 million (or 77% of revenues), for the six month period ended June 30, 2010. This decrease in cost of sales was primarily attributable to a decrease in revenues. The slight increase in our cost of sales as a percentage of revenues was primarily attributable to margin improvements in the second quarter of 2011 that did not fully offset the margin weakness we experienced in the first quarter of 2011 as a result of a greater than normal consulting services segment mix that occurred during the first quarter of 2011. Our Wireless Mobility Management and Cyber Security Solutions segments realized greater margins from the benefit of economies of scale with our direct cost centers realizing greater efficiencies. Our IT Consulting Services and Products segment realized greater margins as a result of a larger mix of higher margin consulting services versus a lesser amount of lower margin software reselling that was realized during the quarter. We anticipate improvements in our costs of sales on a percentage basis as our Wireless Mobility Management and Cyber Security Solutions segments add economies of scale, which may be partially offset at times by the fluctuation in our IT Consulting Services and Products segment revenue mix.

Gross profit. Gross profit for the six month period ended June 30, 2011 was approximately $4.5 million (or 22% of revenues), as compared to gross profit of approximately $5.5 million (or 23% of revenues) for the six month period ended June 30, 2010. The percentage of gross profit was lower in the first half of 2011 as compared to the first half of 2010 as a result of lower margins associated with a greater mix of revenues from our IT Consulting Services and Products segment in our first quarter of 2011. We anticipate gross profit as a percentage of revenues should continue to increase as cost of sales as a percentage of revenues decreases due to a greater mix of higher margin services. We believe as revenues expand in the future there will be periods of variability in margin growth associated with changes in our product mix.

Sales and marketing. Sales and marketing expense for the six month period ended June 30, 2011 was approximately $815,000 (or 4% of revenues), as compared to approximately $831,000 (or 4% of revenues) for the six month period ended June 30, 2010. The dollar amount of sales and marketing decreased slightly as we optimized and aligned our bid and proposal efforts and marketing efforts. We believe that with our niche capabilities and the investment within our sales and marketing will support our ability to expand our revenues.

General and administrative. General and administrative expenses for the six month period ended June 30, 2011 were approximately $3.7 million (or 18% of revenues), as compared to approximately $3.7 million (or 16% of revenues) for the six month period ended June 30, 2010. The slight increase in general and administrative expenses was primarily attributable to increases in non-recurring administrative legal expenses. We anticipate that our general and administrative costs may rise slightly in the future as our support costs rise to facilitate our expectations of a greater revenue base as we continue our efforts to comply with pending additional financial compliance requirements. We believe that our general and administrative costs on a percentage of revenue basis will level out or decrease in future financial reporting periods.

Depreciation. Depreciation expense for the six month period ended June 30, 2011 was approximately $106,000 (or less than 1% of revenues), as compared to approximately $98,000 of such expenses (or less than 1% of revenues) for the six month period ended June 30, 2010. The increase in depreciation expense was primarily attributable to an increased pool of depreciable assets. We do not anticipate any material changes within depreciation expense in the short-term. However, within our Wireless Mobility Management and Cyber Security Solutions segments, there may be a need from time to time to increase the purchase of equipment in support of new revenue streams that may then raise our depreciation expenses.

Interest income. Interest income for the six month period ended June 30, 2011 was approximately $6,700 (or less than 1% of revenues), as compared to approximately $9,000 (or less than 1% of revenues) for the six month period ended June 30, 2010. This decrease in interest income was primarily attributable to lesser amounts of invested cash and cash equivalents, and combined with lower short-term interest rates that were available to the Company on investments in interest bearing accounts. We do not anticipate any material changes in trends in our interest income for the near-term as a result of continuing low short-term interest rates presently payable by financial institutions.

Interest expense. Interest expense for the six month period ended June 30, 2011 was approximately $40,000 (or less than 1% of revenues), as compared to approximately $50,000 (or less than 1% of revenues) for the six month period ended June 30, 2010. This decrease in interest expense was primarily attributable to lesser expenses associated with the debt instruments held by the Company. We anticipate our interest expense will continue to decrease as the Company continues to pay down the principal on its term note held by Cardinal Bank.

Income taxes. Income tax benefit for the six month period ended June 30, 2011 was approximately $50,000, compared to an income tax expense of approximately $117,000 for the six month period ended June 30, 2010. The Company incurred a deferred income tax benefit of approximately $80,000 for the six month period ended June 30, 2011, as compared to a deferred income tax expense of approximately $78,000 for the six month period ended June 30, 2010, as a result of the recognition of a deferred tax liability attributable to the differences in our treatment of the amortization of goodwill for tax purposes versus book purposes as it relates to our acquisition of iSYS in January 2008. As goodwill is amortized for tax purposes but not book purposes and is considered a permanent asset rather than a temporary asset, the related deferred tax liability cannot be reversed until some indeterminate future period when the goodwill either becomes impaired and/or is disposed of.

Net loss. As a result of the factors above, the net loss for the six month period ended June 30, 2011 was approximately $103,000, as compared to the net income of approximately $652,000 for the six months ended June 30, 2010.

Liquidity and Capital Resources

The Company has, since inception, financed its operations and capital expenditures through the sale of preferred and common stock, seller notes (notes that we have executed with sellers of businesses that the Company purchased in order to defer the payment of all or a portion of the applicable purchase price), convertible notes, convertible exchangeable debentures, senior secured loans and the proceeds from the exercise of the warrants related to a convertible exchangeable debenture. During 2010 and through the period ended June 30, 2011, operations were primarily financed with working capital principally with additional contributions from stock option and warrant exercises. The Company has excess liquidity available from its 2010 Commercial Loan Agreement of approximately $5.0 million. We must continue to maintain certain financial covenants in order to continue to have access to this line of credit.

Net cash provided by operating activities for the six months ended June 30, 2011, was approximately $0.2 million, as compared to net cash used in operating activities of $2.8 million for the six months ended June 30, 2010. This increase in net cash provided by operating activities for the six months ended June 30, 2011 was primarily a result of a decrease in accounts receivable during the first half of 2011 as a result of the slow down in billings related to new contract awards which were delayed to as a result of budget and debt ceiling congressional debates. Net cash used in investing activities for the six months ended June 30, 2011, was approximately $505,000, as compared to $438,000 in cash used in investing activities for the six months ended June 30, 2010. The increase in net cash used in investing activities was primarily attributable to greater amounts invested between the comparative periods with leasehold improvements occurring in the first half of 2011 and the asset acquisition of the government business assets of Vuance, Inc. by the Company in the first quarter of 2010. Net cash used in financing activities amounted to approximately $164,000 in the six months ended June 30, 2011, as compared to net cash used in financing activities of approximately $399,000 in the six months ended June 30, 2010. This decrease in net cash used in financing activities primarily related to lesser amounts of options exercises during the six month period ended June 30, 2011 as compared to the six months period ended June 30, 2010.

As of June 30, 2011, the Company had a net working capital of approximately $6.0 million. The Company's primary source of liquidity consists of approximately $5.4 million in cash and cash equivalents and approximately $6.1 million of accounts receivable and unbilled accounts receivable. Current liabilities include approximately $5.8 million in accounts payable and accrued expenses.

The Company's business environment is characterized by rapid technological change, periods of high growth and contraction and is influenced by material events such as mergers and acquisitions, with each of the foregoing able to substantially change the Company's outlook.

The Company has embarked upon several new initiatives to expand revenue growth, which has included both acquisitions and organic growth. The Company requires substantial working capital to fund the future growth of its business, particularly to finance accounts receivable, sales and marketing efforts, and capital expenditures.

Currently there are no material commitments for capital expenditures and software development costs. Future capital requirements will depend on many factors, including the rate of revenue growth, if any, the timing and extent of spending for new product and service development, technological changes and market acceptance of the Company's services.

Management believes that its current cash position is sufficient to meet capital expenditure and working capital requirements for the near term. However, the growth and technological change of the market make it difficult to predict future liquidity requirements with certainty. Over the longer term, the Company must successfully execute its plans to increase revenue and income streams that will generate significant positive cash flows if it is to sustain adequate liquidity without impairing growth or requiring the infusion of additional funds from external sources. Additionally, a major expansion, such as that which occurred with the acquisition of iSYS or any other potential new subsidiaries, might require external financing that could include additional debt or equity capital. There can be no assurance that additional financing, if required, will be available on acceptable terms, if at all, for future acquisitions and/or growth initiatives. The Company presently has an unused credit facility for $5 million that will expire on September 30, 2011. We are presently completing the renewal of this credit facility with Cardinal Bank and expect that it will be renewed prior to the expiration of the present credit facility.

Off-Balance Sheet Arrangements

The Company has no existing off-balance sheet arrangements as defined under SEC regulations.

ITEM 4. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

We maintain disclosure controls and procedures designed to provide reasonable assurance that material information required to be disclosed by us in the reports we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that the information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. We performed an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this report. Based on the existence of the material weaknesses discussed below in "Material Weakness in Internal Control Over Financial Reporting," our management, including our Chief Executive Officer and Chief Financial Officer, concluded that our disclosure controls and procedures were not effective at the reasonable assurance level as of the end of the period covered by this report.

We do not expect that our disclosure controls and procedures will prevent all errors and all instances of fraud. Disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the disclosure controls and procedures are met. Further, the design of disclosure controls and procedures must reflect the fact that there are resource constraints, and the benefits must be considered relative to their costs. Because of the inherent limitations in all disclosure controls and procedures, no evaluation of disclosure controls and procedures can provide absolute assurance that we have detected all our control deficiencies and instances of fraud, if any. The design of disclosure controls and procedures also is based partly on certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions.

Material Weakness in Internal Control Over Financial Reporting

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the Company's annual or interim financial statements will not be prevented or detected on a timely basis.

Management assessed the effectiveness of our internal control over financial reporting as of December 31, 2010. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control-Integrated Framework. Based on this assessment, management concluded that our internal control over financial reporting was not effective as of December 31, 2010 due to the existence of the following material weaknesses:

Inadequate segregation of duties within an account or process. Management has determined that it continued to not have appropriate segregation of duties within our internal controls that would ensure the consistent application of procedures in our financial reporting process by existing personnel. This control deficiency could result in a misstatement of substantially all of our financial statement accounts and disclosures that would result in a material misstatement to the annual or interim financial statements.

Inadequate Policies & Procedures. Management has determined that its existing policies and procedures continued to be limited and/or inadequate in scope to provide staff with guidance or framework for accounting and disclosing financial transactions. This deficiency could result in unintended, misleading entries being made in the financial system and precluding sufficient disclosure of complex transactions.

Lack of sufficient subject matter expertise. Management has determined that it lacks certain subject matter expertise relating to accounting for complex transactions and the disclosure of complex transactions related to accounting for income taxes. Our financial staff currently lacks sufficient training or experience in accounting for complex transactions and the required disclosure therein.

Remediation Plan for Material Weaknesses

The material weaknesses described above in "Material Weaknesses in Internal Control Over Financial Reporting" comprise control deficiencies that we discovered during the financial close process for the December 31, 2010 fiscal period.

Management formulated a remediation plan in the first quarter of 2011 that will be implemented in our fiscal year 2011, which includes: (i) developing a set of policies and procedures to address inadequacies described above; and (ii) augmenting and allowing for additional training and education for select members of our financial staff. In addition, efforts will be made to segregate the data initiation and preparation processes from the data entry process in order to ensure that different employees review data as compared to those who enter data into the financial system.

We believe that these measures, if effectively implemented and maintained, will remediate the material weaknesses discussed above.

Changes in Internal Control Over Financial Reporting

We are currently undertaking the measures discussed above to remediate the material weaknesses discussed under “Material Weaknesses in Internal Control Over Financial Reporting” above. Those measures, described under “Remediation Plan for Material Weaknesses,” were commenced during the first quarter of 2011, will continue to be implemented during our fiscal year 2011, and will materially affect, or are reasonably likely to materially affect, our internal control over financial reporting.

Because of its inherent limitations, a system of internal control over financial reporting can provide only reasonable assurance and may not prevent or detect misstatements. Further, because of changes in conditions, effectiveness of internal controls over financial reporting may vary over time. Our system contains self-monitoring mechanisms, and actions are taken to correct deficiencies as they are identified.

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PART II – OTHER INFORMATION

ITEM 6. EXHIBITS.

| EXHIBIT NO. | DESCRIPTION |
|---|---|
| 31.1 | Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (Filed herewith). |
| 31.2 | Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (Filed herewith). |
| 32 | Certification of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (Filed herewith). |
| 101. | Interactive Data Files |

101.INS**+ XBRL Instance Document

101.SCH**+ XBRL Taxonomy Extension Schema Document

101.CAL**+ XBRL Taxonomy Extension Calculation Linkbase Document

101.DEF**+ XBRL Taxonomy Definition Linkbase Document

101.LAB**+ XBRL Taxonomy Extension Label Linkbase Document

101.PRE**+ XBRL Taxonomy Extension Presentation Linkbase Document

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.

WIDEPOINT CORPORATION

Date: August 15, 2011

/s/ STEVE L. KOMAR
Steve L. Komar
President and Chief Executive Officer

Date: August 15, 2011

/s/ JAMES T. MCCUBBIN
James T. McCubbin
Vice President – Principal Financial
and Accounting Officer