MERGE TECHNOLOGIES INC
Form 10-Q
November 04, 2005

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

FORM 10 Q

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

For the quarterly period ended September 30, 2005

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

For the transition period from to

Commission file number 0 29486

MERGE TECHNOLOGIES INCORPORATED

(Exact name of Registrant as specified in its charter.)

Wisconsin	**39 1600938**
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

6737 West Washington Street, Suite 2250, Milwaukee, WI 53214 5650

(Address of principal executive offices)

(414) 977 4000

(Registrant s telephone number, including area code)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 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 ý No o

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Rule 12b 2 of the Exchange Act). Yes ý No o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

o Yes ý No

As of October 31, 2005, the Registrant had 22,943,954 shares of Common Stock outstanding.

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PART I Financial Information

PART I

Item 1. **Consolidated Financial Statements**

MERGE TECHNOLOGIES INCORPORATED AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(in thousands, except for share data)

		September 30, 2005 (Unaudited)		December 31, 2004
ASSETS				
Current assets:				
Cash and cash equivalents	$	46,465	$	28,067
Accounts receivable, net of allowance for doubtful accounts of $2,330 and $497 at September 30, 2005 and December 31, 2004, respectively		34,251		11,100
Inventory		1,838		1,082
Prepaid expenses		2,502		495
Deferred income taxes		3,023		3,076
Other current assets		2,443		1,417
Total current assets		90,522		45,237
Property and equipment:				
Computer equipment		3,369		5,275
Office equipment		1,261		755
Leasehold improvements		1,308		351
		5,938		6,381
Less accumulated depreciation		2,180		4,884
Net property and equipment		3,758		1,497
Purchased and developed software, net of accumulated amortization of $6,685 and $9,804 at September 30, 2005 and December 31, 2004, respectively		22,633		9,751
Acquired intangibles, net of accumulated amortization of $1,118 and $760 at September 30, 2005 and December 31, 2004, respectively		12,359		1,183
Goodwill		348,575		21,167
Other assets		2,350		108
Total assets	$	480,197	$	78,943
LIABILITIES AND SHAREHOLDERS EQUITY				
Current liabilities:				
Accounts payable	$	6,071	$	2,020
Accrued wages		6,657		1,414
Other accrued liabilities		3,672		1,202
Deferred revenue		12,129		8,678
Total current liabilities		28,529		13,314
Deferred income taxes and other		2,268		2,062
Total liabilities		30,797		15,376
Shareholders equity:				
Preferred stock, $0.01 par value: 3,999,997 shares authorized; zero shares issued and outstanding at September 30, 2005 and December 31, 2004				
Series A Preferred Stock, $0.01 par value: 1,000,000 shares authorized; zero shares issued and outstanding at September 30, 2005 and December 31, 2004				
Special Voting Preferred stock, no par value: one share authorized; zero shares issued and outstanding at September 30, 2005 and December 31, 2004				
Series 2 Special Voting Preferred stock, no par value: one share authorized; zero shares issued and outstanding at September 30, 2005 and December 31, 2004				
Series 3 Special Voting Preferred stock, no par value: one share authorized; one share issued and outstanding at September 30, 2005 and zero shares issued and outstanding at December 31, 2004				

Common Stock, $0.01 par value: 100,000,000 shares authorized; 21,798,842 shares and 13,186,185 shares issued and outstanding at September 30, 2005 and December 31, 2004, respectively		218		132
Common Stock subscribed: 1,112 and 817 shares at September 30, 2005 and December 31, 2004, respectively		18		14
Additional paid in capital		443,046		55,418
Deferred stock compensation		(1,616)		
Retained earnings		5,747		7,411
Accumulated other comprehensive income		1,987		592
Total shareholders equity		449,400		63,567
Total liabilities and shareholders equity	$	480,197	$	78,943

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MERGE TECHNOLOGIES INCORPORATED AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

(in thousands, except for share data)

	Three Months Ended September 30, 2005	Three Months Ended September 30, 2004	Nine Months Ended September 30, 2005	Nine Months Ended September 30, 2004
Net sales:				
Software and other	$ 24,744	$ 6,280	$ 45,608	$ 18,549
Services and maintenance	7,979	3,027	16,389	8,302
Total net sales	32,723	9,307	61,997	26,851
Cost of sales:				
Software and other	2,144	964	5,199	3,040
Services and maintenance	3,451	1,490	7,564	4,525
Amortization	1,211	754	3,897	2,034
Total cost of sales	6,806	3,208	16,660	9,599
Gross profit	25,917	6,099	45,337	17,252
Operating costs and expenses:				
Sales and marketing	4,252	1,683	8,787	5,088
Product research and development	3,513	559	5,914	1,464
General and administrative	4,392	1,258	9,832	3,194
Acquired in process research and development	57		13,046	
Restructuring and other expenses	160		749	
Depreciation and amortization	990	202	2,282	587
Total operating costs and expenses	13,364	3,702	40,610	10,333
Operating income	12,553	2,397	4,727	6,919
Other income (expense):				
Interest expense	(25)	(3)	(24)	(13)
Interest income	330	80	619	183
Other, net	(145)	15	(271)	82
Total other income	160	92	324	252
Income before income taxes	12,713	2,489	5,051	7,171
Income tax expense	4,596	252	6,715	2,083
Net income (loss)	$ 8,117	$ 2,237	$ (1,664)	$ 5,088
Net income (loss) per share basic	$ 0.25	$ 0.17	$ (0.08)	$ 0.39
Weighted average number of common shares outstanding basic	32,491,717	13,039,123	21,722,210	12,964,960
Net income (loss) per share diluted	$ 0.24	$ 0.16	$ (0.08)	$ 0.37
Weighted average number of common shares outstanding diluted	34,271,312	13,748,894	21,722,210	13,773,599

MERGE TECHNOLOGIES INCORPORATED AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(in thousands)

	Nine Months Ended September 30 2005		Nine Months Ended September 30 2004	
Cash flows from operating activities:				
Net income (loss)	$	(1,664)	$	5,088
Adjustments to reconcile net income (loss) to net cash provided by operating activities:				
Depreciation and amortization		6,179		2,620
Amortization of discount on note assumed in merger				11
Provision for doubtful accounts receivable, net of recoveries		1,114		30
In process research and development		13,046		
Stock compensation expense		608		
Deferred income taxes		5,485		1,176
Change in assets and liabilities, excluding effects from acquisitions:				
Accounts receivable		(15,562)		(1,914)
Inventory		162		(201)
Prepaid expenses		(71)		(315)
Accounts payable		(4,799)		104
Accrued wages		534		424
Other accrued liabilities		(20)		379
Deferred revenue		1,309		2,658
Other		(144)		(807)
Net cash provided by operating activities		6,177		9,253
Cash flows from investing activities:				
Cash acquired in acquisitions, net of cash paid		10,594		
Purchases of property and equipment		(1,727)		(328)
Capitalized software development		(2,816)		(2,672)
Net cash provided by (used in) investing activities		6,051		(3,000)
Cash flows from financing activities:				
Proceeds from exercise of stock options		6,081		1,042
Proceeds from employee stock purchase plan		47		54
Principal payment of notes				(227)
Net cash provided by financing activities		6,128		869
Effect of exchange rate changes on cash		42		(16)
Net increase in cash		18,398		7,106
Cash and cash equivalents, beginning of period		28,067		16,871
Cash and cash equivalents, end of period	$	46,465	$	23,977
Supplemental Disclosures of Cash Flow Information:				
Cash paid for income taxes	$	345	$	1,188
Non Cash Investing and Financing Activities:				
Redemption value related to exchangeable Common Stock			$	1
Value of Common Stock and options issued for acquisitions	$	381,689		

MERGE TECHNOLOGIES INCORPORATED AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY

(in thousands, except share data)

	Preferred Stock				Common Stock						
	Shares issued	**Issued amount**	**Shares subscribed**	**Subscribed amount**	**Shares issued**	**Issued amount**	**Additional paid in capital**	**Deferred stock compensation**	**Retained earnings**	**Other comprehensive income**	**Total shareholders equity**
Balance at December 31, 2004		$	817	$ 14	13,186,185	$ 132	$ 55,418	$	$ 7,411	$ 592	$ 63,567
Cedara exchange of share rights into Common Stock					1,687,129	17	(17)				
Stock issued and options granted for acquisitions, net of costs to issue shares	1				5,581,517	56	380,744				380,800
Stock purchased under ESPP			295	4	2,461		43				47
Exercise of stock options					1,341,550	13	6,068				6,081
Deferred stock compensation								(2,132)			(2,132)
Stock compensation expense							92	516			608
Tax benefit on exercise of stock options							698				698
Net loss									(1,664)		(1,664)
Other comprehensive income										1,395	1,395
Balance at September 30, 2005	1	$	1,112	$ 18	21,798,842	$ 218	$ 443,046	$ (1,616)	$ 5,747	$ 1,987	$ 449,400

MERGE TECHNOLOGIES INCORPORATED AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

(in thousands)

	Three Months Ended September 30, 2005	Three Months Ended September 30, 2004	Nine Months Ended September 30, 2005	Nine Months Ended September 30, 2004
Net income (loss)	$ 8,117	$ 2,237	$ (1,664)	$ 5,088
Accumulated other comprehensive income:				
Cumulative translation adjustment (1)	(70)	115	870	106
Unrealized gain on marketable securities (2)	52		26	
Comprehensive net income (loss)	$ 8,099	$ 2,352	$ (768)	$ 5,194

(1) Net of income tax expense (benefit) of ($39) and $73 for the three months ended September 30, 2005 and 2004, respectively, and $484 and $67 for the nine months ended September 30, 2005 and 2004, respectively.

(2) Net of income tax expense of $29 for the three months ended September 30, 2005 and $15 for the nine months ended September 30, 2005.

Merge Technologies Incorporated and Subsidiaries

Notes to Consolidated Financial Statements

(Unaudited and in thousands, except for share data)

(1) *Basis of Presentation and Significant Accounting Policies*

The accompanying unaudited consolidated financial statements have been prepared pursuant to the rules and regulations for reporting on Form 10 Q. Accordingly, certain information and footnotes required by United States of America generally accepted accounting principles (GAAP) for complete financial statements are not included herein. The interim statements should be read in conjunction with the consolidated financial statements and notes thereto included in the latest Annual Report on Form 10 K of Merge Technologies Incorporated, a Wisconsin corporation, and its subsidiaries and affiliates (which we sometimes refer to collectively as Merge, we, us or our). Since June of 2005, we are doing business under the trade name Merge Healthcare.

Our accompanying unaudited consolidated financial statements reflect all adjustments of a normal recurring nature, which are, in the opinion of management, necessary to present a fair statement of our financial position and results of operations.

(a) *Reporting Periods Presented*

The accompanying unaudited consolidated financial statements do not include the results of Cedara Software Corp. (Cedara) prior to the business combination between Merge and Cedara on June 1, 2005 or the results of AccuImage Diagnostics Corp. (AccuImage) prior to our acquisition of AccuImage on January 28, 2005.

(b) *Use of Estimates*

Our consolidated financial statements are prepared in accordance with GAAP. These accounting principles require us to make certain estimates, judgments and assumptions. We believe that the estimates, judgments and assumptions are reasonable, based on information available at the time they are made. As discussed in Note 5, we have preliminarily allocated the purchase price to Cedara s assets and liabilities. To the extent these estimates lead to material differences in the final allocation of purchase price, our consolidated financial statements will be affected.

(c) *Reclassifications*

Certain reclassifications have been made to the 2004 financial statements to conform to the 2005 presentation.

(d) *Functional Currency*

On June 1, 2005, we changed the functional currency of our subsidiary, eFilm Medical Inc. (eFilm), from the Canadian dollar to the United States of America dollar (U. S. Dollar). This change was due to significant changes in the economic facts and circumstances surrounding the operational environment of this subsidiary. As a result of this change, certain long lived assets, which were previously translated from Canadian dollars to U. S. Dollars at the historical exchange rate on the date the asset was acquired, were revalued based upon the exchange rate as of June 1, 2005, leading to a currency translation adjustment, reflected in other comprehensive income, and increase in the value of applicable assets of approximately $1,520.

(e) *Revenue Recognition*

Revenues are derived primarily from the sublicensing and licensing of software, installation and engineering services, training, consulting, and software maintenance and support. Inherent in the revenue recognition process are significant management estimates and judgments, which influence the timing and amount of revenue recognized.

For software arrangements, we recognize revenue according to the American Institute of Certified Public Accountants (AICPA), Statement of Position No. 97 2, *Software Revenue Recognition,* and related amendments (SOP No. 97 2). SOP No. 97 2, as amended, generally requires revenue earned on software arrangements involving multiple elements to be allocated to each element based on the relative fair values of those elements.

Revenue from multiple element software arrangements is recognized using the residual method, pursuant to Statement of Position No. 98 9, *Modification of SOP No. 97 2, Software Revenue Recognition, With Respect to Certain Transactions* (SOP No. 98 9). Under the residual method, revenue is recognized in a multiple element arrangement when vendor specific objective evidence of fair value exists for all of the undelivered elements in the arrangement, but does not exist for one or more of the delivered elements in the arrangement. For sales transactions where the software is incidental, and hardware transactions where no software is involved, we consider the provisions of Staff Accounting Bulletin 104, *Revenue Recognition*, (SAB No. 104) and Financial Accounting Standards Board s (FASB) Emerging Issues Task Force Issue No. 00 21, *Revenue Arrangements with Multiple Deliverables* (EITF No. 00 21).

We allocate revenue to each undelivered element in a multiple element arrangement based on its respective fair value, with the fair value determined by the price charged when that element is sold separately. Specifically, we determine the fair value of the maintenance portion of the arrangement based on the renewal price of the maintenance offered to customers, which is generally stated in the contract, and fair value of the installation and training based upon the price charged when these services are sold separately. If evidence of the fair value cannot be established for undelivered elements of a software sale, the entire amount of revenue under the arrangement is deferred until these elements have been delivered or vendor specific objective evidence of fair value can be established.

Revenue from sublicenses sold on an individual basis and software licenses is recognized upon shipment provided that evidence of an arrangement exists, delivery has occurred and risk of loss has passed to the customer, fees are fixed or determinable and collection of the related receivable is reasonably assured. We assess collectibility based on a number of factors, including past transaction history with the customer and the credit worthiness of the customer. We generally do not request collateral from customers.

Revenue from software usage sublicenses sold through annual contracts and software maintenance and support is deferred and recognized ratably over the contract period. Revenue from installation and engineering services, training, and consulting services is recognized as services are performed.

Revenue from sales of Radiology Information System (RIS) and from RIS/Picture Archiving and Communications Systems (PACS) solutions, where professional services are considered essential to the functionality of the solution sold, is recognized on the percentage of completion method, as prescribed by AICPA Statement of Position 81 1, *Accounting for Performance on Construction Type and Certain Production Type Contracts* (SOP No. 81 1). Percentage of completion is determined by the input method based upon the amount of labor hours expended compared to the total estimated amount of labor hours to complete the project. Total estimated labor hours is based on management s best estimate of the total amount of time it will take to complete a project. These estimates require the use of judgment. A significant change in one or more of these estimates could affect the profitability of one or more of our contracts. We review our contract estimates periodically to assess revisions in contract values and estimated labor hours expended and reflect changes in estimates in the period that such estimates are revised under the cumulative catch up method.

Our Original Equipment Manufacturer (OEM) software products are fully functional upon delivery and do not require significant modification or alteration. Fees for services to OEM customers are billed separately from licenses of our software products. We provide engineering services to our OEM customers under time and-material or fixed price contracts that are generally longer than one year in duration. Under engineering service contracts where the services are performed and costs incurred in proportion with contracted billing schedules, revenue is recognized when the customer may be billed. This method is expected to result in reasonably consistent profit margins over the contract term. For certain fixed price contracts, we use percentage of completion accounting.

For contracts accounted for under SAB No. 104, we generally invoice the customer 10% of the fair value of the products delivered upon completion of hardware installation and acceptance by the customer. As a result of this specific performance obligation and acceptance criteria, we defer the related amount of product fair value and recognize it upon completion of installation and acceptance.

Our policy is to allow returns when we have preauthorized the return. Based on our historical experience of a limited number of returns and our expectation that returns, if any, will be insignificant, we have provided for an allowance for specific potential items only.

(2) Goodwill and Other Intangibles

Goodwill is our primary unamortizable intangible asset. In the nine months ended September 30, 2005, we increased goodwill by $327,408 due to the business combination with Cedara and acquisition of AccuImage, as well as the change in functional currency of eFilm. The changes in the carrying amount of goodwill in the nine months ended September 30, 2005, are as follows:

Balance as of January 1, 2005	$	21,167
Goodwill related to Cedara acquisition		321,270
Goodwill related to AccuImage acquisition		4,805
Change related to functional currency		1,333
Balance as of September 30, 2005	$	348,575

Our intangible assets, other than internally developed software, subject to amortization are summarized as of September 30, 2005 as follows:

	Weighted Average Remaining Amortization Period (Years)		**Gross Carrying Amount**		**Accumulated Amortization**
Purchased technology	5.0	$	16,633	$	2,395
Customer relationships	5.5	$	13,477	$	1,118
Total	5.2	$	30,110	$	3,513

Amortization expense, including impairment charges as a result of overlapping technologies associated with the Cedara transaction, was $2,995 for the nine months ended September 30, 2005. An impairment charge for purchased technology of $67 was recorded in cost of goods sold and a charge for $610 related to customer relationships was recorded in depreciation and amortization in operating costs and expenses. In addition, we recorded an impairment charge of $895 for capitalized development projects as a result of overlapping technologies for the nine months ended September 30, 2005 in cost of goods sold. Estimated aggregate amortization expense for each of the next five years is as follows:

For the remaining three months:	2005	$	1,293
For the year ended December 31:	2006	$	5,172
	2007	$	5,027
	2008	$	4,678
	2009	$	4,391

(3) Earnings Per Share

Basic earnings per share are computed by dividing income available to common shareholders by the weighted average number of shares outstanding. We have made an accounting policy election to use the if converted method for convertible securities that are eligible to participate in Common Stock dividends, if declared; however, the two class method must be used if the effect is more dilutive. Diluted earnings per share reflects the potential dilution that could occur based on the exercise of stock options, unless such exercise would be anti dilutive, with an exercise price of less than the average market price of our Common Stock. The following table sets forth the computation of basic and diluted earnings per share for the three and nine months ended September 30, 2005 and 2004.

	Three Months Ended September 30, 2005	Three Months Ended September 30, 2004	Nine Months Ended September 30, 2005	Nine Months Ended September 30, 2004
Numerator:				
Net income (loss)	$ 8,117	$ 2,237	$ (1,664)	$ 5,088
Allocation of income (loss) to exchangeable shares				(1)
Numerator for net income (loss) per share basic and diluted	$ 8,117	$ 2,237	$ (1,664)	$ 5,087
Denominator:				
Weighted average number of shares of Common Stock outstanding	32,491,717	13,039,123	21,722,210	12,964,960
Effect of stock options	1,779,595	709,771		808,639
Denominator for net income per share diluted	34,271,312	13,748,894	21,722,210	13,773,599
Net income (loss) per share basic	$ 0.25	$ 0.17	$ (0.08)	$ 0.39
Net income (loss) per share diluted	$ 0.24	$ 0.16	$ (0.08)	$ 0.37

The weighted average number of shares of Common Stock outstanding used to calculate basic net income (loss) per share includes exchangeable share equivalent securities for the three and nine months ended September 30, 2005 of 12,571,420 shares and 5,639,801 shares, respectively, and for the three and nine months ended September 30, 2004 of 5,136 and 223,858, respectively.

For the three months ended September 30, 2005 and 2004, options to purchase 35,650 shares and 434,375 shares, respectively, of our Common Stock had exercise prices greater than the average market price of the shares of Common Stock, and, therefore, are not included in the above calculations of net income per share.

For the nine months ended September 30, 2005 and 2004, options to purchase 76,030 shares and 323,500 shares, respectively, of our Common Stock had exercise prices greater than the average market price of the shares of Common Stock, and, therefore, are not included in the above calculations of net income (loss) per share.

As a result of the loss during the nine months ended September 30, 2005, incremental shares from the assumed conversion of employee stock options totaling 1,201,418 shares have been excluded from the calculation of diluted loss per share as their inclusion would have been anti dilutive.

(4) Stock Based Compensation

We maintain four stock based employee compensation plans and one director option plan. We apply the provisions of Statement of Financial Accounting Standards (SFAS), SFAS No. 123, *Accounting for Stock Based Compensation*, as amended (SFAS No. 123), which requires entities to recognize as expense over the vesting period the fair value of all stock based awards on the date of grant. Alternatively, SFAS No. 123 allows entities to continue to apply the provisions of Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees* (APB Opinion No. 25) and provide pro forma disclosures as if the fair value based method defined in SFAS No. 123 had been applied.

We have elected to continue to apply the provisions of APB Opinion No. 25 in accounting for our plans. All stock options under the plans have been granted at exercise prices of not less than the market value at the date of grant, and as a result, no compensation expense has been recorded under APB Opinion No. 25. Stock compensation expense recognized in the accompanying consolidated financial statements is the result of applying purchase accounting to the replacement stock options. Had we determined compensation cost based on the fair value at the grant date under SFAS No. 123, our net income (loss) would have been the pro forma amounts indicated below:

	Three Months Ended September 30, 2005	2004	Nine Months Ended September 30, 2005	2004
Net income (loss), as reported	$ 8,117	$ 2,237	$ (1,664)	$ 5,088
Add: Stock based employee compensation expense included in reported net income, net of related tax	263		362	
Deduct: Total stock based employee compensation expense determined under fair value based method for all awards, net of related tax benefit	(724)	(462)	(1,634)	(869)
Pro forma net income (loss)	$ 7,656	$ 1,775	$ (2,936)	$ 4,219
Earnings (loss) per share:				
Basic as reported	$ 0.25	$ 0.17	$ (0.08)	$ 0.39
Basic pro forma	$ 0.24			