

MERGE TECHNOLOGIES INC  
Form 10-Q  
September 06, 2006

# UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

## FORM 10-Q

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

For the quarterly period ended June 30, 2006

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

**39-1600938**  
(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  No

Indicate by check mark whether the Registrant is a large accelerated filer, accelerated filer or a non-accelerated filer (see definition of accelerated filer and large accelerated filer as defined in Rule 12b-2 of the Exchange Act).

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

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As of August 29, 2006, the Registrant had 29,069,624 shares of Common Stock outstanding.

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**MERGE TECHNOLOGIES INCORPORATED**

**EXPLANATORY NOTE RESTATEMENT OF FINANCIAL INFORMATION**

**This Quarterly Report on Form 10-Q for the three months ended June 30, 2006 includes a restated consolidated balance sheet as of June 30, 2005, restated consolidated statements of operations and consolidated statements of comprehensive income (loss) for the three and six months ended June 30, 2005 and a restated consolidated statement of cash flows for the six months ended June 30, 2005. The Company will not file an amended Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2005. See Item 1, Financial Statements, and Item 4, Controls and Procedures, in Part I of this Quarterly Report on Form 10-Q, including Note 1 of the notes to consolidated financial statements, for more information concerning these restatements. This Quarterly Report on Form 10-Q should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2005 and our Quarterly Report on Form 10-Q for the quarter ended March 31, 2006.**

**PART I****Item 1. Financial Statements**
**MERGE TECHNOLOGIES INCORPORATED AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**  
**(in thousands, except for share data)**

	<b>June 30, 2006</b>	<b>December 31, 2005</b>
	<b>(Unaudited)</b>	
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 60,689	\$ 64,278
Accounts receivable, net of allowance for doubtful accounts of \$1,490 and \$1,892 at June 30, 2006 and December 31, 2005, respectively	15,359	23,624
Inventory	2,616	2,440
Prepaid expenses	2,670	2,646
Deferred income taxes	5,652	11,213
Other current assets	555	3,208
<b>Total current assets</b>	<b>87,541</b>	<b>107,409</b>
Property and equipment:		
Computer equipment	4,559	4,025
Office equipment	1,763	1,759
Leasehold improvements	1,383	1,372
	7,705	7,156
Less accumulated depreciation	3,627	2,716
Net property and equipment	4,078	4,440
Purchased and developed software, net of accumulated amortization of \$9,069 and \$6,759 at June 30, 2006 and December 31, 2005, respectively	18,752	19,539
Acquired intangibles, net of accumulated amortization of \$2,827 and \$1,687 at June 30, 2006 and December 31, 2005, respectively	10,650	11,789
Goodwill	131,092	350,634
Other assets	9,238	7,862
Deferred income taxes	2,442	
<b>Total assets</b>	<b>\$ 263,793</b>	<b>\$ 501,673</b>
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 5,552	\$ 5,938
Accrued wages	4,829	5,870
Taxes payable	3,894	3,894
Other accrued liabilities	3,418	3,453
Deferred revenue	15,935	30,918
<b>Total current liabilities</b>	<b>33,628</b>	<b>50,073</b>
Deferred income taxes		3,491
Deferred revenue	4,671	3,784
Other	420	484
<b>Total liabilities</b>	<b>38,719</b>	<b>57,832</b>
Shareholders' equity:		
Preferred stock, \$0.01 par value: 3,999,997 shares authorized; zero shares issued and outstanding at June 30, 2006 and December 31, 2005		
Series A Preferred Stock, \$0.01 par value: 1,000,000 shares authorized; zero shares issued and outstanding at June 30, 2006 and December 31, 2005		
Special Voting Preferred stock, no par value: one share authorized; zero shares issued and outstanding at June 30, 2006 and December 31, 2005		
Series 2 Special Voting Preferred stock, no par value: one share authorized; zero shares issued and outstanding at June 30, 2006 and December 31, 2005		
Series 3 Special Voting Preferred stock, no par value: one share authorized; one share issued and outstanding at June 30, 2006 and December 31, 2005		
Common stock, \$0.01 par value: 100,000,000 shares authorized: 29,069,624 shares and 26,500,140 shares issued and outstanding at June 30, 2006 and December 31, 2005, respectively	291	265
Common stock subscribed; zero shares and 706 shares at June 30, 2006 and December 31, 2005, respectively		17
Additional paid-in capital	446,647	445,954
Deferred stock compensation		(1,245 )
Accumulated deficit	(223,859 )	(3,190 )
Accumulated other comprehensive income	1,995	2,040

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Total shareholders' equity	225,074	443,841
Total liabilities and shareholders' equity	\$ 263,793	\$ 501,673

See accompanying notes to consolidated financial statements.

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**MERGE TECHNOLOGIES INCORPORATED AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
(Unaudited)  
(in thousands, except for share and per share data)

	Three Months Ended June 30, 2006	2005 (As restated)	Six Months Ended June 30, 2006	2005 (As restated)
Net sales:				
Software and other	\$ 18,770	\$ 11,037	\$ 28,315	\$ 15,685
Services and maintenance	12,952	4,124	19,603	6,413
Total net sales	31,722	15,161	47,918	22,098
Cost of sales:				
Software and other	4,470	1,805	5,842	2,375
Services and maintenance	3,787	2,478	7,473	4,113
Amortization	1,068	1,887	2,345	2,589
Total cost of sales	9,325	6,170	15,660	9,077
Gross profit	22,397	8,991	32,258	13,021
Operating costs and expenses:				
Sales and marketing	5,233	2,810	10,454	4,390
Product research and development	5,083	1,648	10,212	2,401
General and administrative	6,345	3,966	12,186	5,184
Acquired in process R&D		12,989		12,989
Goodwill impairment, restructuring and other expenses	219,462	589	219,484	589
Depreciation and amortization	1,142	1,087	2,184	1,389
Total operating costs and expenses	237,265	23,089	254,520	26,942
Operating loss	(214,868 )	(14,098 )	(222,262 )	(13,921 )
Other income (expense):				
Interest expense	(21 )		(26 )	
Interest income	696	169	1,357	290
Other, net	(216 )	(82 )	(196 )	(126 )
Total other income	459	87	1,135	164
Loss before income taxes	(214,409 )	(14,011 )	(221,127 )	(13,757 )
Income tax expense (benefit)	1,360	1,190	(458 )	1,279
Net loss	\$ (215,769 )	\$ (15,201 )	\$ (220,669 )	\$ (15,036 )
Net loss per share basic	\$ (6.41 )	\$ (0.79 )	\$ (6.56 )	\$ (0.93 )
Weighted average number of common shares outstanding basic				
	33,637,779	19,254,640	33,636,285	16,248,205
Weighted average number of common shares outstanding diluted				
	33,637,779	19,254,640	33,636,285	16,248,205

See accompanying notes to consolidated financial statements.

**MERGE TECHNOLOGIES INCORPORATED AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(Unaudited)  
(in thousands)

	Six Months Ended June 30, 2006	2005 (As restated)
<b>Cash flows from operating activities:</b>		
Net loss	\$ (220,669 )	\$ (15,036 )
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	4,529	3,978
In-process research and development		12,989
Stock-based compensation	1,922	166
Goodwill impairment charge	219,433	
Provision for doubtful accounts receivable, net of recoveries	(95 )	213
Deferred income taxes	(373 )	(960 )
Change in assets and liabilities, excluding effects from acquisitions:		
Accounts receivable	8,363	(4,888 )
Inventory	(176 )	187
Prepaid expenses	(91 )	(210 )
Accounts payable	(444 )	(2,290 )
Accrued wages	(1,040 )	882
Other accrued liabilities	213	(628 )
Deferred revenue	(14,095 )	7,235
Other assets	1,774	(269 )
Other	(255 )	1,860
Net cash provided by (used in) operating activities	(1,377 )	3,229
<b>Cash flows from investing activities:</b>		
Cash acquired in acquisitions, net of cash paid		10,782
Purchases of property, equipment, and leasehold improvements	(549 )	(1,388 )
Purchased technology	(367 )	
Capitalized software development	(1,322 )	(1,781 )
Net cash provided by (used in) investing activities	(2,238 )	7,613
<b>Cash flows from financing activities:</b>		
Proceeds from exercise of stock options	25	848
Proceeds from employee stock purchase plan		29
Net cash provided by financing activities	25	877
Effect of exchange rate changes on cash	1	44
Net increase (decrease) in cash	(3,589 )	11,763
Cash and cash equivalents, beginning of period	64,278	28,067
Cash and cash equivalents, end of period	60,689	\$ 39,830
<b>Supplemental Disclosures of Cash Flow Information:</b>		
Cash paid for income taxes	\$ 69	\$ 911
Value of Common Stock and options issued for acquisitions		\$ 381,689

See accompanying notes to consolidated financial statements.



**MERGE TECHNOLOGIES INCORPORATED AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY**  
**For the Six Months Ended June 30, 2006**  
**(unaudited)**  
**(in thousands, except share data)**

	Preferred Stock		Common Stock				Additional paid-in capital	Deferred stock compensation	Accumulated deficit	Accumulated other comprehensive income	Total shareholders equity
	Shares issued	Issued amount	Shares subscribed	Subscribed amount	Shares issued	Issued amount					
Balance at December 31, 2005	1	\$	706	\$ 17	26,500,140	\$ 265	\$ 445,954	\$ (1,245)	\$ (3,190)	\$ 2,040	\$ 443,841
Cedara exchange of share rights into Common Stock					2,561,085	26	(26)				
Stock purchased under ESPP			(706)	(17)	706		17				
Exercise of employee stock options					7,693		25				25
Reclassification of deferred compensation upon adoption of SFAS No. 123(R)							(1,245)	1,245			
Stock-based compensation							1,922				1,922
Net loss									(220,669)		(220,669)
Unrealized loss on marketable securities										(45)	(45)
Balance at June 30, 2006	1	\$			29,069,624	\$ 291	\$ 446,647		\$ (223,859)	\$ 1,995	\$ 225,074

See accompanying notes to consolidated financial statements.

**MERGE TECHNOLOGIES INCORPORATED AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)**  
(Unaudited)  
(in thousands)

	Three Months Ended		Six Months Ended	
	June 30, 2006	2005 (As restated)	June 30, 2006	2005 (As restated)
Net loss	\$ (215,769 )	\$ (15,201 )	\$ (220,669 )	\$ (15,036 )
Accumulated other comprehensive income:				
Cumulative translation adjustment(1)	2	921	2	951
Unrealized loss on marketable securities(2)	(29 )	(26 )	(29 )	(26 )
Comprehensive net loss	\$ (215,796 )	\$ (14,306 )	\$ (220,696 )	\$ (14,111 )

(1) Net of income tax benefit of \$1 and \$496 for the three months ended June 30, 2006, and 2005, respectively, and \$1 and \$512 for the six months ended June 30, 2006 and 2005, respectively.

(2) Net of income tax expense of \$19 and \$14 for the three months ended June 30, 2006, and 2005, respectively, and \$19 and \$14 for the six months ended June 30, 2006 and 2005, respectively.

See accompanying notes to consolidated financial statements.

**Merge Technologies Incorporated and Subsidiaries**  
**Notes to Consolidated Financial Statements**  
**(Unaudited and in thousands, except for share and per data)**

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

The accompanying unaudited consolidated financial statements have been prepared pursuant to the rules and regulations of Securities and Exchange Commission ( SEC ) 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 Annual Report on Form 10-K for the year ended December 31, 2005 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 2005, we have been 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. The results of operations for any quarter are not necessarily indicative of the results to be expected for any future period.

*Restatement of Consolidated Financial Statements*

From January 10, 2006 through May 26, 2006, we received 11 anonymous letters primarily alleging improprieties relating to our financial reporting, fulfillment of customer contracts and related revenue recognition, and disclosure practices. The Audit Committee of our Board of Directors took a leadership role in assessing these matters and determining the appropriate corrective action with the assistance of outside counsel. The Audit Committee of our Board of Directors retained the independent national law firm of Sidley Austin LLP and Alvarez & Marsal Dispute Analysis and Forensic Services, LLC ( Alvarez & Marsal ), a nationally recognized forensic accounting firm, to conduct an independent investigation of the allegations contained in the anonymous letters. Sidley Austin LLP and Alvarez & Marsal conducted a comprehensive investigation of our accounting and financial reporting practices, which included, among other things, a review of relevant documents and interviews of current and former employees of Merge Healthcare and Cedara Software Corp., which we acquired in June 2005. On May 15, 2006, Richard A. Linden, our former President and Chief Executive Officer, submitted his resignation from all positions with us and our subsidiaries, including as an officer, employee and director, and our Board of Directors accepted Mr. Linden s resignation.

On June 29, 2006, soon after Sidley Austin LLP completed its investigation, Sidley Austin LLP reported its findings to the Audit Committee, and the Audit Committee determined that, because of improper accounting and financial reporting practices with respect to reporting periods in the fiscal years 2002 through 2005, the previously issued financial statements for each of the reporting periods in 2002 through 2005 should no longer be relied upon. Furthermore, the audit reports of KPMG LLP with respect to those previously issued financial statements (including the report of KPMG with respect to management s assessment of, and the effectiveness of, our internal control over financial reporting) should no longer be relied upon. On June 30, 2006, the Audit Committee presented its recommendations to all of our non-employee directors. On July 2, 2006, our Board of Directors held a meeting at which it accepted the resignations of each of William C. Mortimore, our former interim Chief Executive Officer, Scott T. Veech, our former Chief Financial Officer, Treasurer and Secretary, and David M. Noshay, our former Senior Vice President, Strategic Business Development, from all positions with us and our subsidiaries, including as officers, employees and directors.

**Merge Technologies Incorporated and Subsidiaries**  
**Notes to Consolidated Financial Statements (Continued)**  
**(Unaudited and in thousands, except for share and per data)**

The errors identified in previously issued financial statements are described below.

*Revenue Recognition*

We determined that we overstated net sales for 2002, 2003, 2004 and the first nine months of 2005 due to the following:

- Delivery of certain software products to end-user customers that did not fully meet the functionality that we believe our customers expected based on express representations we made to our customers or implied representations that arose from our demonstrations of the software products during the sales process. We have deferred such revenue until the delivery of the expected product functionality, the majority of which occurred in the third and fourth quarters of 2005 and the second quarter of 2006.
- Collectibility was not reasonably assured at the time certain revenue was recognized. Some of our contracts failed to reflect collectibility contingencies expressly demanded by the customer. We have not recognized revenue until collectibility became reasonably assured, generally as cash was collected from the respective customer.
- Recording revenue prior to shipment of the correct products included in a customer's contract. We have deferred revenue until shipment of the appropriate products occurred.
- Recording of revenue prior to shipment of all software products included in a customer's contract. Since we did not have vendor specific objective evidence of fair value for the software element of certain of our contracts, we were required to defer all revenue for certain customer orders with partial software product shipment until delivery of all software products occurred.
- For certain customers' contracts, we were unable to establish vendor specific objective evidence of fair value of maintenance. We have deferred the related contract value and are recognizing revenue ratably over the related maintenance period.
- We determined that we failed to reduce net sales attributable to a contract, although we had agreed to provide the customer with \$200 in additional software at no additional cost to the customer.

In aggregate, these revenue recognition errors resulted in the recognition of previously deferred revenue of approximately \$17,500 for the three months ended June 30, 2006 and \$18,000 for the six months ended June 30, 2006. In aggregate, these revenue recognition errors resulted in the deferral of revenue of approximately \$3,500 for the three months ended June 30, 2005 and \$7,300 for the six months ended June 30, 2005.

*Income Tax Expense*

We determined that we understated income tax expense, income tax payable and goodwill in the amounts of \$1,308, \$3,854 and \$2,546, respectively, for the three and six months ended, and as of, June 30, 2005, due to a failure to record additional tax liability and income tax expense in connection with our June 2005 business combination with Cedara Software Corp.

In addition, we adjusted the provisions for income tax and related tax accounts at the applicable statutory rates to account for the effects of the restatement adjustments described herein.



**Merge Technologies Incorporated and Subsidiaries**  
**Notes to Consolidated Financial Statements (Continued)**  
**(Unaudited and in thousands, except for share and per data)**

*Other Adjustments*

As a result of the revenue adjustments, certain revenue-related accounts were impacted and also restated. These included cost of goods sold related to contracts impacted, other assets, goodwill, deferred revenue, bad debt expense, and the related accounts receivable allowance, accounts receivable, and commission expense.

The following tables summarize the impact of the restatements on our consolidated balance sheet as of June 30, 2005, statements of operations for the three and six months ended June 30, 2005 and statement of cash flows for the six months ended June 30, 2005, and should be read in conjunction with the consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2005 and Quarterly Report on Form 10-Q for the quarter ended March 31, 2006.

**MERGE TECHNOLOGIES INCORPORATED AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**

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	June 30, 2005 (As reported)	Adjustments	June 30, 2005 (As restated)
<b>ASSETS</b>			
Current assets:			
Cash and cash equivalents	\$ 39,830		