

VITAL IMAGES INC  
Form 10-Q  
November 09, 2007

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-Q**

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

For the quarterly period ended September 30, 2007

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 0-22229

**VITAL IMAGES, INC.**

(Exact name of registrant as specified in its charter)

**Minnesota**  
(State or other jurisdiction of

**42-1321776**  
(I.R.S. Employer Identification No.)

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incorporation or organization)

**5850 Opus Parkway, Suite 300**  
**Minnetonka, Minnesota**  
(Address of principal  
executive offices)

**55343-4414**  
(Zip Code)

**(952) 487-9500**

(Registrant's telephone number, including area code)

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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, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

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 Exchange Act).

Yes  No

On November 5, 2007, there were 17,132,240 shares of the Registrant's common stock, par value \$.01 per share, outstanding.

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**Vital Images, Inc.**  
**Form 10-Q**  
**September 30, 2007**

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**Signatures**

## Part I. Financial Information

### Item 1. Financial Statements

#### Vital Images, Inc. Condensed Consolidated Balance Sheets

(In thousands, except per share amounts)  
(Unaudited)

	September 30, 2007	December 31, 2006
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 151,696	\$ 144,382
Marketable securities	17,177	20,821
Accounts receivable, net	14,994	19,589
Deferred income taxes	1,661	1,661
Prepaid expenses and other current assets	2,952	1,928
Total current assets	188,480	188,381
Marketable securities	10,022	750
Property and equipment, net	10,377	9,242
Deferred income taxes	9,268	8,969
Licensed technology, net		90
Other intangible assets, net	2,113	3,209
Goodwill	9,089	9,089
Total assets	\$ 229,349	\$ 219,730
<b>Liabilities and Stockholders Equity</b>		
Current liabilities:		
Accounts payable	\$ 3,091	\$ 3,830
Accrued compensation	3,246	3,977
Accrued royalties	1,292	1,158
Other current liabilities	1,626	2,083
Deferred revenue	15,952	15,131
Total current liabilities	25,207	26,179
Deferred revenue	1,036	1,174
Deferred rent	1,370	1,475
Total liabilities	27,613	28,828
Commitments and contingencies (Note 9)		
Stockholders equity:		
Preferred stock: \$0.01 par value; 5,000 shares authorized; none issued or outstanding		
Common stock: \$0.01 par value; 40,000 shares authorized; 17,128 issued and outstanding as of September 30, 2007; and 16,908 shares issued and outstanding as of December 31, 2006	171	169
Additional paid-in capital	197,552	189,669
Retained earnings	3,973	1,053
Accumulated other comprehensive income	40	11
Total stockholders equity	201,736	190,902
Total liabilities and stockholders equity	\$ 229,349	\$ 219,730

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The accompanying notes are an integral part of the condensed consolidated financial statements.

**Vital Images, Inc.**  
**Condensed Consolidated Income Statements**

(In thousands, except per share amounts)  
(Unaudited)

	For the three months ended September 30,		For the nine months ended September 30,	
	2007	2006	2007	2006
<b>Revenue:</b>				
License fees	\$ 9,406	\$ 11,650	\$ 30,586	\$ 34,036
Maintenance and services	7,464	5,747	22,176	15,243
Hardware	245	384	712	1,211
<b>Total revenue</b>	<b>17,115</b>	<b>17,781</b>	<b>53,474</b>	<b>50,490</b>
<b>Cost of revenue:</b>				
License fees	995	1,116	3,540	3,646
Maintenance and services	2,416	2,048	7,535	5,667
Hardware	133	306	506	859
Impairment of patent	242		242	
<b>Total cost of revenue</b>	<b>3,786</b>	<b>3,470</b>	<b>11,823</b>	<b>10,172</b>
<b>Gross profit</b>	<b>13,329</b>	<b>14,311</b>	<b>41,651</b>	<b>40,318</b>
<b>Operating expenses:</b>				
Sales and marketing	7,380	6,256	22,918	17,630
Research and development	4,039	3,394	11,298	9,530
General and administrative	3,057	2,799	10,127	7,924
<b>Total operating expenses</b>	<b>14,476</b>	<b>12,449</b>	<b>44,343</b>	<b>35,084</b>
<b>Operating income (loss)</b>	<b>(1,147)</b>	<b>1,862</b>	<b>(2,692)</b>	<b>5,234</b>
Interest income	2,294	791	6,687	1,990
<b>Income before income taxes</b>	<b>1,147</b>	<b>2,653</b>	<b>3,995</b>	<b>7,224</b>
Provision for income taxes	220	1,029	1,075	2,926
<b>Net income</b>	<b>\$ 927</b>	<b>\$ 1,624</b>	<b>\$ 2,920</b>	<b>\$ 4,298</b>
<b>Net income per share basic</b>	<b>\$ 0.05</b>	<b>\$ 0.12</b>	<b>\$ 0.17</b>	<b>\$ 0.33</b>
<b>Net income per share diluted</b>	<b>\$ 0.05</b>	<b>\$ 0.12</b>	<b>\$ 0.17</b>	<b>\$ 0.31</b>
<b>Weighted average common shares outstanding - basic</b>	<b>17,019</b>	<b>13,279</b>	<b>16,947</b>	<b>13,140</b>
<b>Weighted average common shares outstanding - diluted</b>	<b>17,364</b>	<b>14,027</b>	<b>17,476</b>	<b>13,941</b>

The accompanying notes are an integral part of the condensed consolidated financial statements.

**Vital Images, Inc.**  
**Condensed Consolidated Statements of Cash Flows**

(In thousands)  
(Unaudited)

	For the nine months ended September 30,	
	2007	2006
Cash flows from operating activities:		
Net income	\$ 2,920	\$ 4,298
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization of property and equipment	3,288	2,021
Amortization of identified intangibles	944	1,053
Impairment of patent	242	
Provision for doubtful accounts	175	
Deferred income taxes	1,075	2,927
Excess tax benefit from stock transactions	(1,334)	(3,222)
Amortization of discount and accretion of premium on marketable securities	(575)	(256)
Employee stock-based compensation	4,237	3,713
Non-employee stock-based compensation		12
Amortization of deferred rent	(248)	(140)
Changes in operating assets and liabilities:		
Accounts receivable	4,420	(2,909)
Prepaid expenses and other assets	(1,025)	(447)
Accounts payable	(300)	(627)
Accrued expenses and other liabilities	(1,428)	(787)
Deferred revenue	683	3,801
Deferred rent	199	
Net cash provided by operating activities	13,273	9,437
Cash flows from investing activities:		
Purchases of property and equipment	(4,861)	(3,304)
Purchases of marketable securities	(36,428)	(25,006)
Proceeds from maturities of marketable securities	30,634	32,937
Proceeds from sale of marketable security	750	
Net cash (used in) provided by investing activities	(9,905)	4,627
Cash flows from financing activities:		
Proceeds from sale of common stock under stock plans	2,612	4,029
Excess tax benefit from stock transactions	1,334	3,222
Net cash provided by financing activities	3,946	7,251
Net increase in cash and cash equivalents	7,314	21,315
Cash and cash equivalents, beginning of period	144,382	20,845
Cash and cash equivalents, end of period	\$ 151,696	\$ 42,160

The accompanying notes are an integral part of the condensed consolidated financial statements.

**Vital Images, Inc.**  
**Notes to Condensed Consolidated Financial Statements (Unaudited)**

## 1. Basis of presentation

The accompanying unaudited condensed consolidated financial statements of Vital Images, Inc. (the Company) have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and notes required by accounting principles generally accepted in the United States of America. In the opinion of management, all adjustments, consisting only of normal recurring adjustments, for a fair statement have been included. Operating results for the three and nine months ended September 30, 2007 are not necessarily indicative of the results that may be expected for any subsequent quarter or for the year ending December 31, 2007. The December 31, 2006 condensed consolidated balance sheet information was derived from audited financial statements but does not include all disclosures required by accounting principles generally accepted in the United States of America. These financial statements should be read in conjunction with the financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

The condensed consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All intercompany accounts and transactions have been eliminated. The Company views its operations and manages its business as one reportable segment—the development and marketing of software and related services for enterprise-wide advanced visualization and analysis solutions for use by medical professionals in clinical analysis and therapy planning. Factors used to identify the Company's single operating segment include the financial information available for evaluation by the chief operating decision maker in making decisions about how to allocate resources and assess performance. The Company markets its products and services through a direct sales force and independent distributors in the United States and international markets.

## 2. Major customer and geographic data

The following customers accounted for more than 10% of the Company's total revenue for at least one of the periods indicated (dollars in thousands):

	For the three months ended September 30,		For the nine months ended September 30,	
	2007	2006	2007	2006
Toshiba Medical Systems Corporation	\$ 8,619	\$ 7,636	\$ 24,736	\$ 20,302
Percentage of total revenue	50%	43%	46%	40%
McKesson Information Systems LLC	\$ 1,782	\$ 1,400	\$ 4,955	\$ 4,909
Percentage of total revenue	10%	8%	9%	10%

As of September 30, 2007 and December 31, 2006, Toshiba Medical Systems Corporation accounted for 33% and 41% of accounts receivable, respectively. As of September 30, 2007 and December 31, 2006, McKesson Information Systems LLC accounted for 11% and 14% of accounts receivable, respectively.





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Revenue by geographic area is summarized as follows (dollars in thousands):

	For the three months ended September 30,		For the nine months ended September 30,	
	2007	2006	2007	2006
United States	\$ 14,261	\$ 14,831	\$ 44,103	\$ 42,493
Europe	1,711	1,711	5,615	4,360
Asia and Pacific Region	529	486	1,781	1,627
Other Foreign Countries	614	753	1,975	2,010
Totals	\$ 17,115	\$ 17,781	\$ 53,474	\$ 50,490
Export revenue as a percent of total revenue	17%	17%	18%	16%

Substantially all of the Company's export sales are negotiated, invoiced and paid in U.S. dollars.

### 3. Equity-based compensation

On January 1, 2006, the Company adopted Statement of Financial Accounting Standards ( SFAS ) No. 123 (revised 2004), Share-Based Payment ( SFAS 123(R) ), which requires the measurement and recognition of compensation expense for all equity-based payment awards based on estimated fair values.

The following table illustrates how equity-based compensation was allocated to the income statements (in thousands):

	For the three months ended September 30,		For the nine months ended September 30,	
	2007	2006	2007	2006
Cost of revenue	\$ 88	\$ 98	\$ 300	\$ 277
Sales and marketing	646	544	1,782	1,530
Research and development	202	156	528	639
General and administrative	555	486	1,627	1,279
Total equity-based compensation expense	\$ 1,491	\$ 1,284	\$ 4,237	\$ 3,725

As of September 30, 2007, approximately \$10.1 million of unrecognized compensation expense related to stock options was expected to be recognized over a weighted-average period of 2.6 years. As of September 30, 2007, approximately \$1.5 million of unrecognized compensation expense related to restricted stock awards was expected to be recognized over a weighted-average period of 1.9 years.

The fair value of each option award is estimated on the date of grant using the Black-Scholes option valuation model. The Black-Scholes option valuation model requires the development of assumptions that are input into the model. These assumptions are the expected stock volatility, the risk-free interest rate, the option's expected life and the dividend yield on the underlying stock.

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For purposes of calculating the fair value of options under SFAS 123(R), the weighted-average fair value of options granted was \$8.27 and \$13.73 for the three and nine months ended September 30, 2007, respectively, and \$12.01 and \$13.45 for the three and nine months ended September 30, 2006, respectively. The weighted-average fair values for the options were based on the fair values on the dates of grant. The fair values for the options were calculated

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using the Black-Scholes option-pricing model, with the following weighted-average assumptions and expense adjusted using the following expected forfeiture rate assumptions:

	For the three months ended September 30,		For the nine months ended September 30,	
	2007	2006	2007	2006
Expected option life	3.75 years	3.75 years	3.75 years	3.78 years
Expected volatility factor	50%	56%	52%	51%
Expected dividend yield	0%	0%	0%	0%
Risk-free interest rate	4.32%	4.72%	4.49%	4.67%
Expected forfeiture rate	1.01%	1.12%	1.06%	1.12%

In the first quarter of 2007, the Company granted shares of restricted stock with performance-based vesting to certain employees. The Company granted a total of 13,500 restricted shares with a total grant-date fair value of \$464,000. The awards vest upon achievement of certain Company performance metrics for fiscal years 2007 through 2009. One-third of each award will vest on each of the Company's Form 10-K filing dates for the years ending December 31, 2007, 2008 and 2009 if the performance metrics are met for the respective fiscal year. Should the performance metrics not be met for a given year, the unvested portion will carry forward to the next fiscal year and may vest if that year's metric is met. As of the Company's Form 10-K filing date for the year ended December 31, 2009, any unvested portion of the award will be forfeited. As of September 30, 2007, the Company did not consider the achievement of the performance metrics for the year ending December 31, 2007 to be probable. Therefore, no equity-based compensation expense for the awards was recognized for the nine months ended September 30, 2007. The amount of the expense related to the awards not recognized as of September 30, 2007 but which may be recognized in future periods if performance metrics are met was \$87,000. The first quarter of 2007 was the first period in which the Company granted restricted stock awards with performance-based vesting.

The following table summarizes stock option activity for the nine months ended September 30, 2007:

	Shares Underlying Options
Total outstanding as of December 31, 2006	1,797,179
Options granted	449,945
Options exercised	(202,689)
Options cancelled	(44,655)
Total outstanding as of September 30, 2007	1,999,780

Options granted during the nine months ended September 30, 2007 primarily consisted of the Company's annual grant to employees in the first quarter of 2007.

#### 4. Per share data

Basic net income per share is computed using net income and the weighted-average number of common shares outstanding. Diluted net income per share reflects the weighted-average number of common shares outstanding plus any potentially dilutive shares outstanding during the period. Potentially dilutive shares consist of shares issuable upon the exercise of stock options, as well as unvested restricted stock.



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The computations for basic and diluted net income per share are as follows (in thousands, except per share amounts):

	For the three months ended September 30,		For the nine months ended September 30,	
	2007	2006	2007	2006
<b>Numerator:</b>				
Net income	\$ 927	\$ 1,624	\$ 2,920	\$ 4,298
<b>Denominator:</b>				
Denominator for weighted average common shares outstanding - basic	17,019	13,279	16,947	13,140
Dilution associated with the Company's stock-based compensation plans	345	679	529	778
Dilution associated with contingent stock consideration relating to acquisition of HInnovation, Inc.		69		23
Denominator for weighted average common shares outstanding - diluted	17,364	14,027	17,476	13,941
Net income per share - basic	\$ 0.05	\$ 0.12	\$ 0.17	\$ 0.33
Net income per share - diluted	\$ 0.05	\$ 0.12	\$ 0.17	\$ 0.31
Antidilutive stock options and restricted stock awards excluded from above calculation	1,012	344	800	281

## 5. Comprehensive income

Comprehensive income as defined by SFAS No. 130, Reporting Comprehensive Income (SFAS 130), includes net income and items defined as other comprehensive income. SFAS 130 requires that items defined as other comprehensive income, such as unrealized gains and losses on certain marketable securities, be separately classified in the financial statements. Such items are reported in the consolidated statements of stockholders' equity as comprehensive income.

The components of comprehensive income were as follows (in thousands):

	For the three months ended September 30,		For the nine months ended September 30,	
	2007	2006	2007	2006
Net income	\$ 927	\$ 1,624	\$ 2,920	\$ 4,298
<b>Other comprehensive income:</b>				
Net change in unrealized gain or loss on available-for-sale investments, net of tax	12	6	6	17
Cumulative translation adjustment	15		23	
Comprehensive income	\$ 954	\$ 1,630	\$ 2,949	\$ 4,315

## 6. Other intangible assets

Acquired intangible assets subject to amortization were as follows (in thousands):

	September 30, 2007			December 31, 2006		
	Gross Carrying Value	Accumulated Amortization	Net Carrying Value	Gross Carrying Value	Accumulated Amortization	Net Carrying Value
Existing software technology	\$ 3,400	\$ (2,479)	\$ 921	\$ 3,400	\$ (1,966)	\$ 1,434
Patents and patent applications	2,500	(1,308)	1,192	3,000	(1,242)	1,758
Non-compete/employment agreements				500	(483)	17
Total intangible assets subject to amortization	\$ 5,900	\$ (3,787)	\$ 2,113	\$ 6,900	\$ (3,691)	\$ 3,209

During the three months ended September 30, 2007, the Company recognized a \$242,000 patent impairment charge related to a patent application acquired in the HInnovation, Inc. acquisition in February 2004. This patent application was rejected by the United States Patent and Trademark Office ( Patent Office ) on August 23, 2007, and the Company decided not to pursue this application further.

Intangible assets subject to amortization are amortized on a straight-line basis over the estimated period of benefit. Amortization expense related to other intangible assets was \$279,000 and \$321,000 for the three months ended September 30, 2007 and 2006, respectively. Amortization expense related to other intangible assets was \$854,000 and \$963,000 for the nine months ended September 30, 2007 and 2006, respectively. The estimated future amortization expense for identified intangible assets as of September 30, 2007 is as follows (in thousands):

Remainder of 2007	\$ 261
2008	1,044
2009	426
2010	360
2011	22
	\$ 2,113

The preceding expected amortization expense is an estimate. Actual amortization expense may differ from estimates due to additional intangible asset acquisitions, impairment of intangible assets, accelerated amortization of intangible assets and other events. A patent acquired in the HInnovation, Inc. acquisition having a \$950,000 net book value as of September 30, 2007 is currently under review by the Patent Office.

## 7. Deferred revenue

The components of deferred revenue were as follows:

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	September 30, 2007	December 31, 2006
Maintenance and support	\$ 11,538	\$ 10,750
Training	3,390	4,272
Installation	577	476
Software	1,003	409
Hardware and other	480	398
Total deferred revenue	16,988	16,305
Less current portion	(15,952)	(15,131)
Long-term portion of deferred revenue	\$ 1,036	\$ 1,174



## 8. Income taxes

Effective January 1, 2007, the Company adopted Financial Accounting Standards Board ( FASB ) Interpretation No. 48, Accounting for Uncertainty in Income Taxes ( FIN 48 ). FIN 48 prescribes a recognition threshold and measurement attribute for recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. The adoption of FIN 48 did not have a material impact on the Company's condensed consolidated financial statements. Additionally, the adoption of FIN 48 had no impact on retained earnings or the gross liability for uncertain tax positions.

The Company did not have any material unrecognized tax benefits as of the date of the adoption of FIN 48 or as of September 30, 2007. The Company recognizes potential accrued interest and penalties related to unrecognized tax benefits as a component of income tax expense. To the extent interest and penalties are not assessed with respect to uncertain tax positions, amounts accrued will be reduced and reflected as a reduction of the overall income tax provision. The Company recorded no interest and penalties during the three and nine months ended September 30, 2007 and had no accrued interest and penalties as of September 30, 2007. The Company is no longer subject to U.S. federal tax examinations by tax authorities for tax years before 2003. The Company is open to state tax audits until the applicable statute of limitations expires.

The Company's consolidated effective income tax rate was 19.2% and 38.8% for the three months ended September 30, 2007 and 2006, respectively, and 26.9% and 40.5% for the nine months ended September 30, 2007 and 2006, respectively. The Company's consolidated effective income tax rate was 35.9% for the fiscal year 2006. The provision for income taxes consists of provisions for federal, state and foreign income taxes. The consolidated income tax rate is a composite rate of the various jurisdictions and the applicable rates. The decrease in the estimated effective tax rate for 2007 from the fiscal year 2006 is primarily due to a decrease in the estimated pretax results and that research and development credits have a greater impact on the effective tax rate at lower income levels.

The Company reviews its annual effective income tax rate on a quarterly basis and makes changes as necessary. The estimated annual effective income tax rate may fluctuate due to changes in forecasted annual pretax income; changes to the valuation allowance for net deferred tax assets; changes to actual or forecasted permanent book to tax differences; impacts from future tax settlements with state, federal or foreign tax authorities; or impacts from tax law changes. In addition, the Company identifies items which are not normal and recurring in nature and treats these as discrete events which are booked entirely in the quarter in which the discrete event occurs.

In assessing the realizability of the Company's deferred tax assets as of September 30, 2007, the Company considered evidence regarding its ability to generate sufficient future taxable income to realize its deferred tax assets. The primary evidence considered included the cumulative pretax income for financial reporting purposes for the three years ended September 30, 2007; the estimated impact of future tax deductions from the exercise of stock options outstanding as of September 30, 2007; and the estimated future taxable income based on historical operating results.

After giving consideration to these factors, the Company determined that there was no need to adjust its valuation allowance for deferred tax assets. Based on this analysis, it is more likely than not that the tax loss carryforwards will be realized prior to their expiration and that other tax credits that expire prior to 2010 will not be utilized due to the estimated future tax deductions from the exercise of stock options outstanding as of September 30, 2007 as well as utilization of tax loss carryforwards. As a result, the Company had a valuation allowance of \$185,000 as of September 30, 2007 and December 31, 2006 relating to net operating losses and tax credits that expire prior to 2010.

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If the Company adjusts either its estimates of future taxable income or tax deductions from the exercise of stock options, or the Company's stock price increases significantly without an increase in its taxable income, causing the Company to believe that its deferred tax assets will not be utilized, the Company may need to establish additional

valuation allowances on its deferred tax assets, which could materially impact its financial position and results of operations.

## 9. Commitments and contingencies

### Operating lease commitments

The Company rents office space and certain office equipment under operating leases. In addition to minimum lease payments, the office leases require payment of a proportionate share of real estate taxes and building operating expenses. The minimum lease payments, excluding estimated taxes and operating cost rent obligations, are approximately the following amounts (in thousands):

Remainder of 2007	\$	253
2008		902
2009		869
2010		888
2011		907
Thereafter		76
Total	\$	3,895

### Other items

Under general contract terms, the Company often includes provisions in its software license agreements under which the Company indemnifies its customers against liability and damages arising from claims of patent, copyright, trademark or trade secret infringement by the Company's software. The Company has not incurred any material costs as a result of this type of indemnification clause, and the Company does not maintain a product warranty liability related to such indemnification clauses.

The Company has entered into various employment agreements with certain executives of the Company, which include provisions for severance payments subject to certain conditions and events.

The Company is involved in various claims and legal actions in the normal course of business. Management is of the opinion that the outcome of such legal actions will not have a significant adverse effect on the Company's financial position, results of operations or cash flows. Notwithstanding management's belief, an unfavorable resolution of some or all of these matters could materially affect our future results of operations or cash flows.

## 10. New Accounting Pronouncements

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In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements ( SFAS 157 ), which defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles and expands disclosures about fair value measurements. SFAS 157 applies to other accounting standards that require or permit fair value measurements. Accordingly, it does not require any new fair value measurement. SFAS 157 will be effective for the Company on January 1, 2008. The Company is currently evaluating the impact the adoption of SFAS 157 will have on its financial position and results of operations.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities ( SFAS 159 ), which permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. SFAS 159 will be effective for the Company on January 1, 2008. The Company is currently evaluating the impact the adoption of SFAS 159 will have on its financial position and results of operations.

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

**Executive summary**

Vital Images, Inc. (also referred to as we, us and our) third quarter 2007 results were an improvement from our 2007 second quarter results but below our 2006 third quarter. We believe the decrease in revenue was due to several factors, principally the following:

**Slowdowns in the computed tomography (CT) scanner and picture archive and communication systems (PACS) markets** The slowdowns in the scanner and PACS markets negatively affected our ability to increase revenue to the extent we anticipated at the beginning of the quarter. We believe customers are anticipating the release of next-generation, faster CT scanners and delaying purchases until they become available.

**Deficit Reduction Act** The Deficit Reduction Act of 2005, or the DRA, which was signed into law on February 8, 2006, imposes caps on Medicare payment rates for certain imaging services, including CT, furnished in physicians' offices and other non-hospital based settings. Under the caps, payments for specified imaging services cannot exceed the hospital outpatient payment rates for these services. This change applies to services furnished on or after January 1, 2007. The DRA also codifies a reduction in Medicare payments for certain multiple images performed on contiguous body parts, which was previously established in the 2006 Physician Fee Schedule final rule. Although the majority of our revenue is generated from sales to hospitals instead of the imaging centers that are the focus of the DRA, we believe that the DRA may also be delaying or negatively impacting some hospital purchasing decisions, such as for hospitals with internal imaging centers.

**Execution** A substantial portion of our direct sales (that is, sales generated other than through our resellers, such as Toshiba Medical Systems Corporation (Toshiba) and McKesson Information Systems, LLC (McKesson)) close in the last month of each quarter. In the third quarter of 2007, we closed a lower percentage of these sales than we had closed historically.

The above factors had a substantial negative impact on our financial results for the third quarter of 2007.

Revenue decreased 4% to \$17.1 million, compared to \$17.8 million for the third quarter of 2006.

Gross margin decreased to 78%, compared to 80% for the third quarter of 2006.

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Income before taxes was \$1.1 million, compared to \$2.7 million for the third quarter of 2006.

Net income was \$927,000, or \$0.05 per diluted share, compared to \$1.6 million, or \$0.12 per diluted share, for the 2006 third quarter.

Our results for the nine months ended September 30, 2007 show moderate year-over-year revenue growth, offset by increased expenses.

Total revenue increased 6% to \$53.5 million for the nine months ended September 30, 2007, compared to \$50.5 million in the year-ago period.

Gross margin decreased to 78% for the nine months ended September 30, 2007, compared to 80% for the same period in 2006.

Income before taxes decreased to \$4.0 million, compared to pretax income of \$7.2 million in the year-ago period.

Net income decreased to \$2.9 million, or \$0.17 per diluted share, compared to \$4.3 million, or \$0.31 per diluted share, for the same period in 2006.

Our cash, cash equivalents and marketable securities position continued to strengthen during the three and nine months ended September 30, 2007. Total cash, cash equivalents and marketable securities was \$178.9 million as of September 30, 2007, compared to \$175.8 million as of June 30, 2007 and \$166.0 million as of December 31, 2006. Working capital (defined as current assets less current liabilities) increased to \$163.3 million as of September 30, 2007, compared to \$160.3 million as of June 30, 2007 and \$162.2 million as of December 31, 2006.

Throughout our history, a significant portion of our revenue has been generated from the U.S. radiology CT market. Going forward, we anticipate a growing contribution from other sources, including sales from the PACS market, sales to medical specialists in areas other than radiology, sales of Web-based products, international sales and sales to our growing installed customer base.

### **Overview of our business**

We are a leading provider of enterprise-wide advanced visualization and image analysis solutions for use by medical professionals in clinical analysis and therapy planning for medical conditions. We provide software, training, software maintenance, professional services and, on occasion, third-party hardware to our customers. Our technology rapidly transforms complex data generated by diagnostic imaging equipment into functional digital images that can be manipulated and analyzed using our specialized applications to better understand internal anatomy and pathology. Our solutions are designed to improve physician workflow and productivity, enhance the ability to make clinical decisions, facilitate less invasive patient care, and complement often significant capital investments in diagnostic imaging equipment made by our customers. Our software is compatible with equipment from all major manufacturers of diagnostic imaging equipment, such as computed tomography, or CT, magnetic resonance, or MR, and positron emission tomography, or PET, scanners, and can be integrated into PACS. Many hospitals use PACS to acquire, distribute and archive medical images and diagnostic reports, reducing the need for film and increasing reliance on advanced visualization solutions such as ours. We also offer a Web-based solution that provides physicians with anywhere, anytime access to medical images and visualization tools through any Internet-enabled computer.

Vitrea® Software, our flagship software product, is an easy-to-use, intuitive, high-speed volume rendering technology that creates interactive two-dimensional, or 2D, three-dimensional, or 3D, and four-dimensional, or 4D, images from information generated by standard CT, MR or PET scanners. Vitrea is commonly deployed on standalone workstations, as well as on PACS, using standard computer hardware, and provides advanced visualization for radiological, cardiac, oncological and surgical applications. Vitrea renders vibrant, clear, color images at high speeds and enables users to interactively navigate within these images to visualize, measure and understand internal structures and disease conditions. We believe our user interfaces are intuitive, and they are specifically configured to assist physicians in optimizing their clinical workflow. VitreaACCESS -Remote Software provides physicians remote access to the full suite of advanced visualization and analysis tools provided by Vitrea software. It offers a cost effective solution designed to enable users to leverage workstations by allowing secure access to Vitrea applications from any personal computer in a facility or from external locations through a virtual private network, or VPN.

ViTALConnect® Software, our Web-based solution, allows multiple physicians to collaboratively use enterprise-wide advanced visualization in their medical practices. It provides radiologists and referring physicians anywhere, anytime access to interactive 2D, 3D and 4D medical images and the ability to measure, rotate, analyze and segment those images. Our latest release includes features previously available only on multimodality workstations, such as a variety of multi-planar reformat, or MPR, modes, thick slab rendering in MPR, 3D volumetric visualization with simple point of interest navigation, 4D dataset visualization, CT/PET fusion and advanced analysis tools.

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We also offer enterprise-wide advanced visualization options that can expand the relevance of our products beyond the radiology department to referring physicians and surgical specialists, particularly in the areas of cardiology, cardiovascular, oncology, neurology and gastroenterology. Our advanced visualization options allow physicians to customize their Vitrea software according to their unique requirements. Most options are proprietary; however, Vitrea also serves as an integration platform for the applications offered by our visualization technology partners. Vitrea's add-on options include:

Vitrea Option	Clinical Use
VScore	Quantify calcium in the four major coronary arteries
CT Brain Perfusion	Analyze the blood flow of stroke victims
Innerview GI (virtual colonoscopy)	Locate and analyze polyps in the colon
Automated Vessel Measurements	Characterize the course and dimensions of diseased blood vessels
CT Cardiac	Determine the extent of obstructive coronary artery disease
SUREPlaque	Aid in evaluating, characterizing and quantifying plaque inside the coronary arteries
Vessel Probe	Define vascular anatomy and the extent of obstruction in vessels other than the coronary arteries
CT Lung and Lung Tools	Visualize and measure nodules in the lungs
ImageChecker® CT	Detect pulmonary nodules in the chest
Fusion7D	Visualize images and fuse studies from multiple modalities, such as MR and PET
CADstream	Analyze MR breast exams
QMass MR	Analyze MR cardiac images
EP Planning	3D advanced visualization and modeling tool for the electrophysiology lab

Our software solutions are used with medical diagnostic equipment, primarily in clinical analysis and therapy planning. Our software applies proprietary technologies to a variety of data supplied by CT, MR and PET scanners to allow medical clinicians to create 2D, 3D and 4D views of human anatomy and to non-invasively navigate within these images to better visualize and understand internal structures and pathologies. We market Vitrea and ViTALConnect both as standalone software packages and as part of integrated software and hardware systems to radiologists, cardiologists, surgeons, other specialized physicians, primary care physicians and medical researchers. Our main customers are hospitals and clinics, university medical schools and diagnostic imaging companies. We market our products and services to these customers both directly through our own sales force and indirectly through digital imaging equipment manufacturers and PACS companies, who sell our products with products they either manufacture or acquire from third parties.

Our products work with equipment from all major manufacturers of diagnostic imaging systems, including Toshiba, GE Medical Systems, Siemens Medical Systems, Inc. and Philips Medical Systems. Our products may also be integrated into PACS, such as those marketed by McKesson, Sectra AB and DR Systems, Inc., and run on off-the-shelf third-party computer hardware.

We operate and manage our business as a single business segment – the development and marketing of software and related services for enterprise-wide advanced visualization and analysis solutions for use by medical professionals in clinical analysis and therapy planning. We market our products and services through a direct sales force, resellers and independent distributors in the United States and in international markets. Our common stock is currently traded on The NASDAQ Global Select Market under the symbol – VTAL.

### Critical accounting policies and estimates



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Our discussion and analysis of financial condition and results of operations are based upon our condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. We have adopted various accounting policies to prepare the condensed

consolidated financial statements in accordance with accounting principles generally accepted in the United States of America. The most significant accounting policies are disclosed in Note 2 to the consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2006. The preparation of these financial statements requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates. We continually evaluate our critical accounting policies and estimates. We discuss our critical accounting estimates in Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the fiscal year ended December 31, 2006. The adoption of FIN 48 was the only significant change in our critical accounting policies or estimates since December 31, 2006.

*Income Taxes*

Our operations involve dealing with uncertainties and judgments in the application of complex tax regulations in a multitude of jurisdictions. The final taxes paid are dependent upon many factors, including negotiations with taxing authorities in various jurisdictions and resolution of disputes arising from federal, state and international tax audits. We recognize potential liabilities and record tax liabilities for anticipated tax audit issues in the U.S. and other tax jurisdictions based on our estimate of whether, and the extent to which, additional taxes will be due. As of January 1, 2007, we follow FIN 48 guidance to record these liabilities (refer to Note 8 for additional information). We adjust these reserves in light of changing facts and circumstances; however, due to the complexity of some of these uncertainties, the ultimate resolution may result in a payment that is materially different from our current estimate of the tax liabilities. If our estimate of tax liabilities proves to be less than the ultimate assessment, an additional charge to expense would result. If payment of these amounts ultimately proves to be less than the recorded amounts, the reversal of the liabilities would result in tax benefits being recognized in the period when we determine the liabilities are no longer necessary.

**Results of Operations**

The following table sets forth information from our Condensed Consolidated Income Statements, expressed as a percentage of total revenue.

	For the three months ended September 30,		For the nine months ended September 30,	
	2007	2006	2007	2006
<b>Revenue:</b>				
License fees	55.0%	65.5%	57.2%	67.4%
Maintenance and services	43.6	32.3	41.5	30.2
Hardware	1.4	2.2	1.3	2.4
Total revenue	100.0	100.0	100.0	100.0
<b>Cost of revenue:</b>				
License fees	5.8	6.3	6.6	7.2
Maintenance and services	14.1	11.5	14.1	11.2
Hardware	0.8	1.7	0.9	1.7
Impairment of patent	1.4		0.5	
Total cost of revenue	22.1	19.5	22.1	20.1
Gross profit	77.9	80.5	77.9	79.9
<b>Operating expenses:</b>				
Sales and marketing	43.1	35.2	42.9	34.9
Research and development	23.6	19.1	21.1	18.9
General and administrative	17.9	15.7	18.9	15.7
Total operating expenses	84.6	70.0	82.9	69.5
Operating income (loss)	(6.7)	10.5	(5.0)	10.4
Interest income	13.4	4.4	12.5	3.9
Income before income taxes	6.7	14.9	7.5	14.3
Provision for income taxes	1.3	5.8	2.0	5.8
Net income	5.4%	9.1%	5.5%	8.5%

**Revenue (dollars in thousands)**

	For the three months ended September 30,				For the nine months ended September 30,			
	2007	2006	Change		2007	2006	Change	
<b>Revenue:</b>								
License fees	\$ 9,406	\$ 11,650	\$ (2,244)	(19)%	\$ 30,586	\$ 34,037	\$ (3,451)	(10)%
Maintenance and services	7,464	5,747	1,717	30%	22,176	15,243	6,933	45%
Hardware	245	384	(139)	(36)%	712	1,210	(498)	(41)%
Total revenue	\$ 17,115	\$ 17,781	\$ (666)	(4)%	\$ 53,474	\$ 50,490	\$ 2,984	6%

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Revenue for the three and nine months ended September 30, 2007 was affected primarily by decreased sales of software licenses in the second and third quarters of 2007 primarily due to the slowdowns in the CT scanner and PACS markets, offset by increased maintenance and services revenue from a larger installed base of customers.

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License fee revenue (dollars in thousands)

	For the three months ended September 30,				For the nine months ended September 30,				
	2007	2006	Change		2007	2006	Change		
License fee revenue:									
Vitreia licenses	\$ 3,111	\$ 4,196	\$ (1,085)	(26)%	\$ 10,027	\$ 13,632	\$ (3,605)	(26)%	
Vitreia options and third party software	5,869	7,184	(1,315)	(18)%	19,296	19,387	(91)	(0)%	
Other	426	270	156	58%	1,263	1,018	245	24%	
Total license fee revenue	\$ 9,406	\$ 11,650	\$ (2,244)	(19)%	\$ 30,586	\$ 34,037	\$ (3,451)	(10)%	

The decrease in license fee revenue during the three and nine months ended September 30, 2007 was driven primarily by a decrease in the number of Vitrea licenses sold. Sales of Vitrea options and third-party software during the 2007 third quarter did not decrease at the same rate as Vitrea license sales due to continued sales of add-on options to our installed base of existing customers. Top-selling options for the three and nine months ended September 30, 2007 and 2006 were General Vessel Probe, Automated Vessel Measurement and CT Cardiac all cardiovascular solutions. The following table sets forth information on license fee revenue by source:

	For the three months ended September 30,		For the nine months ended September 30,	
	2007	2006	2007	2006
Percent of license fee revenue:				
Direct	26%	43%	36%	45%
Toshiba	63	49	55	44
McKesson	11	8	9	11
Total license fee revenue	100%	100%	100%	100%

Maintenance and services revenue (dollars in thousands)

	For the three months ended September 30,			For the nine months ended September 30,				
	2007	2006	Change	2007	2006	Change		
Maintenance and services revenue:								
Maintenance and support	\$ 5,862	\$ 4,269	\$ 1,593	37%	\$ 16,747	\$ 11,367	\$ 5,380	47%
Training	1,350	1,189	161	14%	4,517	3,166	1,351	43%
Installation	252	289	(37)	(13)%	912	710	202	28%
Total maintenance and services	\$ 7,464	\$ 5,747	\$ 1,717	30%	\$ 22,176	\$ 15,243	\$ 6,933	45%

The increase in maintenance and support revenue for the three and nine months ended September 30, 2007, compared to the same periods in 2006, was due to a significant increase in our installed base of customers, increased pricing on maintenance related services and an increased

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maintenance renewal rate. The increase in training revenue for the three and nine months ended September 30, 2007, compared to the same periods in 2006, was due to an increase in the number of Vitrea licenses sold and the recognition of revenue from the expiration of rights held by customers to receive training for our software during the three and nine months ended September 30, 2007. Revenue from the expiration of training rights for the three and nine months ended September 30, 2007 was \$415,000 and \$1.0 million, respectively. No revenue was recognized during the same periods in 2006 from the expiration of training rights because we began to recognize revenue from the expiration of customer rights to receive training in the fourth quarter of 2006. Installation revenue increased due to the timing of installations and increased pricing for installation services.

**Hardware revenue**

Hardware revenue decreased 36% to \$245,000 in the third quarter of 2007, compared to \$384,000 in the third quarter of 2006. Hardware revenue decreased 41% to \$712,000 during the nine months ended September 30, 2007, compared to \$1.2 million in the same period for 2006. We sell hardware as a convenience to our customers, and fluctuations in hardware revenue are driven by individual customer purchasing preferences. Sales of hardware systems are not core to our strategy and will fluctuate from period to period depending upon the needs of our customers.

**Cost of revenue and gross profit**

A comparison of gross profit and gross margin by revenue category is as follows (dollars in thousands):

	For the three months ended				For the nine months ended			
	September 30,		Change		September 30,		Change	
	2007	2006			2007	2006		
<b>Gross profit:</b>								
License fees	\$ 8,412	\$ 10,535	\$ (2,123)	(20)%	\$ 27,047	\$ 30,391	\$ (3,344)	(11)%
Maintenance and services	5,047	3,699	1,348	36%	14,640	9,576	5,064	53%
Hardware	112	77	35	45%	206	351	(145)	(41)%
Impairment of patent	(242)		(242)	(100)%	(242)		(242)	(100)%
Total gross profit	\$ 13,329	\$ 14,311	\$ (982)	(7)%	\$ 41,651	\$ 40,318	\$ 1,333	3%
<b>Gross margin:</b>								
License fees	89%	90%			88%	89%		
Maintenance and services	68%	64%			66%	63%		
Hardware	46%	20%			29%	29%		
Total gross margin (1)	78%	80%			78%	80%		

(1) Total gross margin percentage reflects patent impairment charges of \$242,000 for the three and nine months ended September 30, 2007 that are not included in the revenue category gross profit percentages in this table.

The decrease in license fee gross margin for the three and nine months ended September 30, 2007 compared to the same periods in 2006 was due in part to an increase in the percentage of our total license fee revenue that we received from our relationship with Toshiba, as Toshiba-related sales have lower average revenue per license. Amortization charged to cost of revenue related to the acquisition of HInnovation, Inc. in February 2004 was \$279,000 for the third quarters of both 2007 and 2006 and \$837,000 for the first nine months of both 2007 and 2006. The HInnovation, Inc. amortization costs represented 3% of license fee revenue for the three and nine months ended September 30, 2007 and 2% for the three and nine months ended September 30, 2006.

Maintenance and services gross margin increased during the three and nine months ended September 30, 2007, compared to the same periods in 2006, due to increased pricing on maintenance services as well as increased revenue from a growing installed base without an increase in costs at

a similar rate. We will continue to invest in our training, installation, professional services and customer support areas to adequately support our growing installed base of customers. We will also continue to evaluate maintenance and services pricing as our cost structure increases, which could have an impact on maintenance and services gross margins in the future.

Hardware gross margin increased for the three months ended September 30, 2007 due to more steeply discounted prices on hardware sales during the same period in 2006. The gross margin for the first nine months of 2007 was consistent with the same period in 2006.

Total gross margin for the three and nine months ended September 30, 2007 was affected by a \$242,000 impairment charge related to a patent application acquired in the HInnovation, Inc. acquisition in February 2004. This patent



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application was rejected by the United States Patent and Trademark Office ( Patent Office ) on August 23, 2007, and we have decided not to pursue this application further. Another patent acquired in the HInnovation, Inc. acquisition having a \$950,000 net book value as of September 30, 2007 is currently under review by the Patent Office.

### Operating expenses

The following is a comparison of operating expenses as a percent of revenue as well as the percent increase in total expense:

	Percent of revenue for the three months ended September 30, 2007	Percent of revenue for the three months ended September 30, 2006	Percent increase for the three months ended September 30, 2006 to 2007	Percent of revenue for the nine months ended September 30, 2007	Percent of revenue for the nine months ended September 30, 2006	Percent increase for the nine months ended September 30, 2006 to 2007
Operating expenses:						
Sales and marketing	43.1%	35.2%	18%	42.9%	34.9%	30%
Research and development	23.6	19.1	19%	21.1	18.9	19%
General and administrative	17.9	15.7	9%	18.9	15.7	28%
Total operating expenses	84.6%	70.0%	16%	82.9%	69.5%	26%

### Sales and marketing

Sales and marketing expenses increased to \$7.4 million in the third quarter of 2007, compared to \$6.3 million in the third quarter of 2006, and increased to \$22.9 million in the for the first nine months of 2007, compared to \$17.6 million for the first nine months of 2006. The change in sales and marketing expenses is as follows (dollars in thousands):

	Increase (decrease) from the three months ended September 30, 2006 to 2007		Increase (decrease) from the nine months ended September 30, 2006 to 2007	
	Amount	Percent	Amount	Percent
Salaries, benefits and bonuses	\$ 678	30%	\$ 2,453	39%
Overhead and other expenses	247	26%	1,048	44%
Travel, meals and entertainment	298	47%	880	48%
Trade shows and advertising	(31)	(12)%	800	68%
Depreciation	150	78%	443	82%
Equity-based compensation	102	19%	252	16%
Commissions	(320)	(23)%	(588)	(15)%
Total	\$ 1,124	18%	\$ 5,288	30%

The increase in sales and marketing expenses for the three and nine months ended September 30, 2007, compared to the same periods in 2006, was primarily due to an increase in compensation costs as a result of additional personnel, higher costs for attending industry tradeshows, higher travel and entertainment costs and increased overhead and other expenses due to the growth in the operating infrastructure. Commission expense decreased due to sales representatives being significantly below plan relative to the prior year. At the beginning of 2007, we increased the number of our United States sales zones from four to six to enable greater focus in each area. We had 104 and 75 sales and marketing personnel as of September 30, 2007 and 2006, respectively.

We will continue to manage sales and marketing expenses based on market conditions and business opportunities.

**Research and development**

Research and development expenses increased \$645,000 to \$4.0 million in the third quarter of 2007, compared to \$3.4 million in the third quarter of 2006, and increased \$1.8 million to \$11.3 million for the nine months ended September 30, 2007, compared to \$9.5 million for the same period in 2006. The change in research and development expenses is as follows (dollars in thousands):

	Increase (decrease) from the three months ended September 30, 2006 to 2007		Increase (decrease) from the nine months ended September 30, 2006 to 2007	
	Amount	Percent	Amount	Percent
Salaries, benefits and bonuses	\$ 453	20%	\$ 1,705	28%
Overhead and other expenses	201	35%	289	17%
Depreciation	44	20%	276	55%
Equity-based compensation	46	29%	(111)	(17)%
Consulting	(99)	(48)%	(391)	(54)%
Total	\$ 645	19%	\$ 1,768	19%

The increase in research and development expenses for the three and nine months ended September 30, 2007 was primarily due to an increase in compensation costs as a result of additional personnel focused on product innovation and development. We had 118 and 93 research and development personnel as of September 30, 2007 and 2006, respectively. The increase in depreciation is due to the acquisition of computer equipment resulting from an increase in headcount and significant capital additions during 2006. The decrease in equity-based compensation for the nine months ended September 30, 2007 was primarily due to a \$146,000 one-time charge recorded in the first quarter of 2006 related to the retirement of Vincent Argiro, our former Chief Technology Officer and founder. During 2006, we added a significant number of research and development personnel, which allowed us to rely less on outside consulting as a total percentage of research and development expenses during the three and nine months ended September 30, 2007.

We will continue to devote resources to develop applications focused on cardiovascular disease and oncology, PACS integration and Web-based solutions that help physicians across the hospital enterprise better serve their patients.

**General and administrative**

General and administrative expenses increased \$258,000 to \$3.1 million in the third quarter of 2007, compared to \$2.8 million in the third quarter of 2006, and increased \$2.2 million to \$10.1 million for the first nine months of 2007, compared to \$7.9 million for the same period in 2006. The change in general and administrative expenses is as follows (dollars in thousands):

	Increase (decrease) from the three months ended September 30, 2006 to 2007		Increase from the nine months ended September 30, 2006 to 2007	
	Amount	Percent	Amount	Percent
Overhead and other expenses	\$ 115	20%	\$ 602	34%
Accounting, auditing and legal fees	27	13%	446	56%
Consulting	110	51%	432	83%
Salaries, benefits and bonuses	(63)	(5)%	375	11%

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Equity-based compensation		69	14%	348	27%
Total	\$	258	9%	\$ 2,203	28%

The increase in general and administrative expenses during the three and nine months ended September 30, 2007, compared to the same periods in 2006, was primarily due to increases in overhead, accounting, auditing, legal, and consulting

expenses due to growth in the operating infrastructure and international expansion. The decrease in salaries, benefits and bonuses was primarily the result of reduced bonus accruals in 2007. We had 53 and 47 general and administrative personnel as of September 30, 2007 and 2006, respectively.

### **Equity-based compensation**

On January 1, 2006, we adopted Statement of Financial Accounting Standards ( SFAS ) No. 123 (revised 2004), Share-Based Payment ( SFAS 123(R) ), which requires the measurement and recognition of compensation expense for all equity-based payment awards based on estimated fair values. A table illustrating the allocation of equity-based compensation to the income statements is included at Note 3 to the Condensed Consolidated Financial Statements.

Equity-based compensation increased \$207,000 to \$1.5 million for the three months ended September 30, 2007, compared to \$1.3 million in the same quarter in 2006, and increased \$512,000 to \$4.2 million for the nine months ended September 30, 2007, compared to \$3.7 million in the same period in 2006. The increases in equity-based compensation allocated to cost of revenue, sales and marketing and general and administrative expenses were due to increases in headcount for the three and nine months ended September 30, 2007, compared to the same periods in 2006. Equity-based compensation allocated to research and development expense increased during the third quarter of 2007, compared to the 2006 third quarter, due to increased headcount, and decreased for the nine months ended September 30, 2007, compared to the same period in 2006, due to the \$146,000 one-time charge recorded in the first quarter of 2006 related to the retirement of Vincent Argiro, who was our Chief Technology Officer and the founder of the company.

### **Interest income**

We generated \$2.3 million of interest income in the third quarter of 2007, compared to \$791,000 in the third quarter of 2006, and generated \$6.7 million for the first nine months of 2007, compared to \$2.0 million for the first nine months of 2006. The increase for the three and nine months ended September 30, 2007, compared to the same periods in 2006, was primarily due to a higher balance of cash, cash equivalents and marketable securities, a result of the secondary offering completed in November 2006 of 3.4 million shares of common stock for net proceeds of \$97.7 million, as well as cash generated by operations. Interest income represented 13.4% and 4.4% of revenue in the third quarter of 2007 and 2006, respectively, and represented 12.5% and 3.9% of revenue during the first nine months of 2007 and 2006, respectively.

### **Income taxes**

Our consolidated effective income tax rate was 19.2% and 38.8% for the three months ended September 30, 2007 and 2006, respectively, 26.9% and 40.5% for the nine months ended September 30, 2007 and 2006, respectively, and 35.9% for fiscal year 2006. The provision for income taxes consists of provisions for federal, state and foreign income taxes. The consolidated income tax rate is a composite rate of the various jurisdictions and the applicable rates. The decrease in the estimated effective tax rate from fiscal year 2006 is primarily due to a decrease in the estimated pretax results and that research and development credits have a greater impact on the effective tax rate at lower income levels. We expect an effective tax rate of approximately 5% to 30% in 2007 before the impact of discrete items, such as the tax benefit from disqualifying dispositions of incentive stock options, which are booked entirely in the quarter in which the event occurs. This wide range is the result of the decrease in the estimated pretax results and the fact that research and development credits have a greater impact on the effective tax rate at lower income levels.

We review our annual effective income tax rate on a quarterly basis and make changes as necessary. The estimated annual effective income tax rate may fluctuate due to changes in forecasted annual pretax income; changes to the valuation allowance for net deferred tax assets; changes to actual or forecasted permanent book to tax differences; impacts from future tax settlements with state, federal or foreign tax authorities; or impacts from tax law changes. In addition, we identify items which are not normal and recurring in nature and treat these as discrete events which are booked entirely in the quarter in which the discrete event occurs.

In assessing the realizability of our deferred tax assets as of September 30, 2007, we considered evidence regarding our ability to generate sufficient future taxable income to realize our deferred tax assets. The primary evidence considered included the cumulative pretax income for financial reporting purposes for the three years ended September 30, 2007; the estimated impact of future tax deductions from the exercise of stock options outstanding as of September 30, 2007; and the estimated future taxable income based on historical operating results.

After giving consideration to these factors, we determined that there was no need to adjust our valuation allowance for deferred tax assets. Based on this analysis, it is more likely than not that the tax loss carryforwards will be realized prior to their expiration and that other tax credits that expire prior to 2010 will not be utilized due to the estimated future tax deductions from the exercise of stock options outstanding as of September 30, 2007 as well as utilization of tax loss carryforwards. As a result, we had a valuation allowance of \$185,000 as of September 30, 2007 and December 31, 2006 relating to net operating losses and tax credits that expire prior to 2010.

If we adjust either our estimates of future taxable income or tax deductions from the exercise of stock options, or our stock price increases significantly without an increase in our taxable income, causing us to believe that our deferred tax assets will not be utilized, we may need to establish additional valuation allowances on our deferred tax assets, which could materially impact our financial position and results of operations.

Effective January 1, 2007, we adopted Financial Accounting Standards Board Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48). FIN 48 prescribes a recognition threshold and measurement attribute for recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. The adoption of FIN 48 did not have a material impact on our condensed consolidated financial statements. Additionally, the adoption of FIN 48 had no impact on retained earnings or the gross liability for uncertain tax positions.

### **Liquidity and capital resources**

As of September 30, 2007, we had \$178.9 million in cash, cash equivalents and marketable securities, working capital (defined as current assets less current liabilities) of \$163.3 million and no borrowings, as compared to \$166.0 million in cash, cash equivalents and marketable securities, working capital of \$162.2 million and no borrowings as of December 31, 2006.

#### *Operating activities*

During the first nine months of 2007, cash provided by operations was \$13.3 million, which consisted of net income of \$2.9 million, an increase of \$7.8 million from other non-cash operating activities, primarily equity-based compensation and depreciation, an increase of \$2.4 million from changes in working capital accounts, and an increase of \$199,000 in deferred rent relating to payments made by our Minnetonka landlord for our benefit. Changes in working capital accounts primarily related to a decrease in accounts receivable of \$4.4 million due to decreased sales in the third quarter of 2007, and an increase in deferred revenue of \$683,000 due to increased maintenance and service contracts and an increased customer base in 2007. Our aging remains relatively current, with less than 10% of receivables greater than 90 days past due as of September 30, 2007 and December 31, 2006. The increases in cash were offset by a decrease in accrued expenses and other liabilities of \$1.4 million due primarily to the payment in 2007 of 2006 bonuses; an increase in prepaid expenses and other current assets of \$1.0 million due primarily to increases in prepaid insurance and estimated tax payments paid in the 2007 second quarter; and a decrease in accounts payable of \$300,000 due to the general timing of vendor payments.

During the first nine months of 2006, cash provided by operations was \$9.4 million, which consisted of net income of \$4.3 million, an increase of \$6.1 million from other non-cash operating activities, and a decrease of \$969,000 from changes in working capital accounts. Changes in working capital accounts primarily related to an increase in accounts receivable of \$2.9 million due to timing of customer payments; a decrease in accrued expenses and other liabilities of \$787,000 due primarily to the payment in 2006 of 2005 bonuses; a decrease in accounts payable of \$627,000 due to the general timing of vendor payments; and an increase in prepaid expenses and other current assets



of \$447,000 due primarily to an increase in prepaid insurance. The decreases in cash were offset by an increase in deferred revenue of \$3.8 million due to increased sales and an increased customer base.

*Investing activities*

Net cash used in investing activities was \$9.9 million during the first nine months of 2007. Net cash provided by investing activities was \$4.6 million during the first nine months of 2006.

We used \$4.9 million for purchases of property and equipment during the nine months ended September 30, 2007, compared to \$3.3 million for the same period in 2006. The purchases for all periods were principally to expand our facilities, upgrade computer equipment, purchase computer equipment for new personnel, and begin implementation of an enterprise resource planning (ERP) system. We anticipate that we will continue to purchase property and equipment in the normal course of business. The amount and timing of these purchases and the related cash outflows in future periods are difficult to predict and depend on a number of factors, including the hiring of employees and the rate of change of computer hardware.

We used \$36.4 million to purchase investments in marketable securities during the first nine months of 2007, compared to \$25.0 million for the same period in 2006. We realized \$31.4 million of proceeds from maturities and sales of marketable securities during the first nine months of 2007, compared to \$32.9 million for the same period in 2006. As of September 30, 2007, our marketable securities consisted of U.S. government obligations, U.S. government agency obligations and corporate commercial obligations.

*Financing activities*

Cash provided by financing activities totaled \$3.9 million and \$7.3 million for the first nine months of 2007 and 2006, respectively. Proceeds from the sale of common stock under stock plans were \$2.6 million and \$4.0 million during the first nine months of 2007 and 2006, respectively. The remaining increase in the first nine months of 2007 and 2006 related to the excess tax benefit from stock transactions.

We have never paid or declared any cash dividends and do not intend to pay dividends in the foreseeable future.

Off-balance-sheet arrangements

We did not have any off-balance sheet arrangements as of September 30, 2007 or December 31, 2006.

Other purchase commitments

We had no significant outstanding purchase orders as of September 30, 2007. We have entered into a number of technology licensing agreements that provide for the payment of royalties when we sell Vitrea and ViTALConnect. We are not obligated for any minimum payments under such agreements.

**Foreign currency transactions**

Substantially all of our foreign transactions are negotiated, invoiced and paid in U.S. dollars.

**Inflation**

We believe inflation has not had a material effect on our operations or financial condition.

**Recent accounting pronouncements**

In September 2006, the Financial Accounting Standards Board ( FASB ) issued SFAS No. 157, Fair Value Measurements ( SFAS 157 ), which defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles and expands disclosures about fair value measurements.

SFAS 157 applies to other accounting standards that require or permit fair value measurements. Accordingly, it does not require any new fair value measurement. SFAS 157 will be effective for us on January 1, 2008. We are currently evaluating the impact the adoption of SFAS 157 will have on our financial position and results of operations.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities ( SFAS 159 ), which permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. SFAS 159 will be effective for us on January 1, 2008. We are currently evaluating the impact the adoption of SFAS 159 will have on our financial position and results of operations.

### Cautionary Statement Regarding Forward-Looking Information

*Vital Images desires to take advantage of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995 (the Reform Act ) and is filing this cautionary statement in connection with the Reform Act. This Quarterly Report on Form 10-Q and any other written or oral statements made by or on our behalf may include forward-looking statements that reflect our current views with respect to future events and future financial performance. Certain statements in this Quarterly Report on Form 10-Q are forward-looking statements within the meaning of Section 27(a) of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. You can identify these forward-looking statements by our use of the words believes, anticipates, forecasts, projects, could, plans, expects, may, will, would, intends, estimates and similar expressions, whether in the negative or affirmative. We wish to caution you that any forward-looking statements made by us or on our behalf are subject to uncertainties and other factors that could cause such statements to be wrong. We cannot guarantee that we actually will achieve these plans, intentions or expectations. Actual results or events could differ materially from the plans, intentions and expectations disclosed in the forward-looking statements that we make. These statements are only predictions and speak only of our views as of the date the statements were made. Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, and/or performance of achievements. We do not assume any obligation to update or revise any forward-looking statements that we make, whether as a result of new information, future events or otherwise.*

*Factors that may impact forward-looking statements include, among others, our abilities to maintain the technological competitiveness of our current products, develop new products, successfully market our products, respond to competitive developments, develop and maintain partnerships with providers of complementary technologies, identify and close mergers and acquisitions, manage our costs and the challenges that may come with growth of our business, and attract and retain qualified sales, technical and management employees. We are also affected by the growth and regulation of the medical technology industry, including the acceptance of enterprise-wide advanced visualization by hospitals, clinics, and universities, product clearances and approvals by the United States Food and Drug Administration and similar regulatory bodies outside the United States, and reimbursement and regulatory practices by Medicare, Medicaid, and private third-party payer organizations. We are also affected by other factors identified in our filings with the Securities and Exchange Commission, some of which are set forth in the section entitled Item 1A.Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2006 (and many of which we have discussed in prior filings). Although we have attempted to list comprehensively these important factors, we also wish to caution investors that other factors may prove to be important in the future in affecting our operating results. New factors emerge from time to time, and it is not possible for us to predict all of these factors, nor can we assess the impact each factor or combination of factors may have on our business.*

### Item 3. Quantitative and Qualitative Disclosures about Market Risk

For information regarding our exposure to certain market risks, see Item 7A, Quantitative and Qualitative Disclosures About Market Risk, in our Annual Report on Form 10-K for the fiscal year ended December 31, 2006, which is hereby incorporated herein. There have been no significant changes in the financial instruments or market risk exposures from the amounts and descriptions disclosed therein.



#### **Item 4. Controls and Procedures**

##### **Evaluation of disclosure controls and procedures**

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in the reports that we file or submit under the Securities Exchange Act of 1934, as amended ( Exchange Act ), is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission, and that such 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 financial disclosure.

Our management, under the supervision of and with the participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, as of the end of the period covered by this report. Based on such evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of the period covered by this report, our disclosure controls and procedures were effective.

##### **Limitations on the effectiveness of controls**

Our management is responsible for establishing and maintaining adequate internal control over financial reporting. Our internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with established policies or procedures may deteriorate.

##### **Changes in internal control over financial reporting**

During the third quarter of 2007, we implemented the general ledger, purchasing, accounts payable and materials management modules of our new enterprise resource planning, or ERP, system. We plan to implement additional modules in 2008 to support the majority of our other processes and operations. We believe the phased-in approach we are taking reduces the risks associated with the implementation. We have taken the necessary steps to monitor and maintain appropriate internal controls during this period of change. These steps include providing training related to business process changes and the ERP system software to individuals using the ERP system to carry out their job responsibilities as well as those who rely on the financial information. Oversight activities have increased during the transition period and a support organization has been established to monitor system operations, answer user questions, resolve issues in a timely manner, and report trends to management. Also, redundant controls have been established in key areas to assure the accuracy of financial reporting. We anticipate that the implementation of the ERP will strengthen the overall system of internal controls due to enhanced automation and integration of related processes. Testing of the controls related to these new systems is ongoing and is included in the scope of our assessment of our internal control over financial reporting for 2007. There were no changes in internal control over financial reporting during the quarter ended September 30, 2007 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.



**Part II. Other Information**

**Item 1. Legal Proceedings**

None.

**Item 1A. Risk Factors**

The discussion of our business and operations included in this Quarterly Report on Form 10-Q should be read together with the risk factors described in Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2006. They describe various risks and uncertainties to which we are or may become subject. These risks and uncertainties, together with other factors described elsewhere in this report, have the potential to affect our business, financial condition, results of operations, cash flows, strategies or prospects in a material and adverse manner. New risks may emerge at any time, and we cannot predict those risks or estimate the extent to which they may affect financial performance.

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

None.

**Item 3. Defaults upon Senior Securities**

None.

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

None.

**Item 5. Other Information**

None.

**Item 6. Exhibits**

The following exhibits are filed with this Quarterly Report on Form 10-Q:

- 31.1 Certification of Chief Executive Officer Pursuant to Rules 13a-14(a)/15d-14(a) under the Securities Exchange Act of 1934 (filed herewith electronically).
- 31.2 Certification of Chief Financial Officer Pursuant to Rules 13a-14(a)/15d-14(a) under the Securities Exchange Act of 1934 (filed herewith electronically).
- 32.1 Section 1350 Certification of Chief Executive Officer (filed herewith electronically).
- 32.2 Section 1350 Certification of Chief Financial Officer (filed herewith electronically).



**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.

November 9, 2007

VITAL IMAGES, INC.

/s/ Michael H. Carrel  
Michael H. Carrel  
Chief Operating Officer and

Chief Financial Officer

(Chief Financial Officer and

Chief Accounting Officer)