VITAL IMAGES INC
Form 10-Q
November 02, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2006

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

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

Indicate by check mark whether the registrant is 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 o Accelerated filer x Non-accelerated filer o

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

Yes o No x

On October 31, 2006, there were 13,427,934 shares of the Registrant s common stock, par value $.01 per share, outstanding.

Vital Images, Inc.
Form 10-Q
September 30, 2006

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Part I. Financial Information

Item 1. Financial Statements

Vital Images, Inc.
Condensed Consolidated Balance Sheets
(Unaudited)

	September 30, 2006	December 31, 2005
Assets		
Current assets:		
Cash and cash equivalents	$ 42,160,294	$ 20,844,640
Marketable securities	21,317,085	28,965,329
Accounts receivable, net	17,238,976	14,330,087
Deferred income taxes	717,000	717,000
Prepaid expenses and other current assets	1,674,972	1,227,586
Total current assets	83,108,327	66,084,642
Property and equipment, net	7,434,083	5,361,319
Deferred income taxes	9,331,694	8,949,000
Licensed technology, net	120,000	210,000
Other intangible assets, net	3,530,000	4,493,000
Goodwill	9,136,597	6,052,744
Total assets	$ 112,660,701	$ 91,150,705
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$ 2,802,309	$ 2,639,608
Accrued compensation	3,814,845	3,687,866
Accrued royalties	998,385	1,347,660
Other current liabilities	1,305,823	1,575,215
Deferred revenue	14,350,296	11,230,578
Total current liabilities	23,271,658	20,480,927
Deferred revenue	1,326,402	645,230
Deferred rent	1,080,716	1,235,051
Total liabilities	25,678,776	22,361,208
Commitments and contingencies (Note 9)		
Stockholders equity:		
Preferred stock: $0.01 par value; 5,000,000 shares authorized; none issued or outstanding		
Common stock: $0.01 par value; 20,000,000 shares authorized; 13,418,234 issued and outstanding as of September 30, 2006 (see Note 9); and 12,847,744 issued and outstanding as of December 31, 2005	134,182	128,478
Additional paid-in capital	88,082,479	75,918,201
Deferred stock-based compensation		(1,707,013)
Accumulated deficit	(1,231,933)	(5,530,236)
Accumulated other comprehensive loss	(2,803)	(19,933)
Total stockholders equity	86,981,925	68,789,497
Total liabilities and stockholders' equity	$ 112,660,701	$ 91,150,705

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

Vital Images, Inc.
Condensed Consolidated Income Statements
(Unaudited)

	For the three months ended September 30, 2006	2005	For the nine months ended September 30, 2006	2005
Revenue:				
License fees	$ 11,650,340	$ 9,026,325	$ 34,036,795	$ 24,315,398
Maintenance and services	5,746,752	3,637,486	15,242,843	10,498,844
Hardware	383,935	496,079	1,210,573	1,618,821
Total revenue	17,781,027	13,159,890	50,490,211	36,433,063
Cost of revenue:				
License fees	1,115,870	1,080,454	3,645,921	3,504,491
Maintenance and services	2,047,813	1,494,219	5,666,557	4,118,011
Hardware	306,263	321,046	859,881	975,475
Total cost of revenue	3,469,946	2,895,719	10,172,359	8,597,977
Gross profit	14,311,081	10,264,171	40,317,852	27,835,086
Operating expenses:				
Sales and marketing	6,256,123	4,108,277	17,629,895	11,577,813
Research and development	3,394,078	2,162,628	9,530,032	5,926,126
General and administrative	2,799,134	1,681,345	7,924,116	5,196,596
Loss on operating lease				493,000
Total operating expenses	12,449,335	7,952,250	35,084,043	23,193,535
Operating income	1,861,746	2,311,921	5,233,809	4,641,551
Interest income	791,696	268,465	1,990,494	669,494
Income before income taxes	2,653,442	2,580,386	7,224,303	5,311,045
Provision for income taxes	1,029,000	959,000	2,926,000	1,932,000
Net income	$ 1,624,442	$ 1,621,386	$ 4,298,303	$ 3,379,045
Net income per share basic	$ 0.12	$ 0.13	$ 0.33	$ 0.27
Net income per share diluted	$ 0.12	$ 0.12	$ 0.31	$ 0.26
Weighted average common shares outstanding - basic	13,279,490	12,476,721	13,140,168	12,291,856
Weighted average common shares outstanding - diluted	14,026,973	13,337,034	13,940,898	13,147,058

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

Vital Images, Inc.
Condensed Consolidated Statements of Cash Flows
(Unaudited)

	For the nine months ended September 30, 2006	2005
Cash flows from operating activities:		
Net income	$ 4,298,303	$ 3,379,045
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	2,020,884	1,585,901
Amortization of identified intangibles	1,053,000	1,053,000
Provision for doubtful accounts		(159,395)
Deferred income taxes	2,927,000	(24,000)
Tax benefit from stock transactions		1,956,000
Excess tax benefit from stock transactions	(3,222,265)	
Amortization of discount and accretion of premium on marketable securities	(255,856)	186,942
Employee stock-based compensation	3,712,781	190,688
Non-employee stock-based compensation	12,650	11,358
Loss on operating lease		493,000
Amortization of deferred rent	(140,312)	(118,635)
Changes in operating assets and liabilities:		
Accounts receivable	(2,908,889)	(4,442,055)
Prepaid expenses and other assets	(447,386)	(400,973)
Accounts payable	(626,873)	(286,444)
Accrued expenses and other liabilities	(786,695)	388,206
Deferred revenue	3,800,890	1,275,197
Deferred rent		1,180,354
Net cash provided by operating activities	9,437,232	6,268,189
Cash flows from investing activities:		
Purchases of property and equipment	(3,304,300)	(3,596,525)
Purchases of marketable securities	(25,006,274)	(21,593,850)
Maturities of marketable securities	32,937,504	7,867,000
Net cash provided by (used in) investing activities	4,626,930	(17,323,375)
Cash flows from financing activities:		
Proceeds from sale of common stock under stock plans	4,029,227	3,272,429
Excess tax benefit from stock option transactions	3,222,265	
Net cash provided by financing activities	7,251,492	3,272,429
Net increase in cash and cash equivalents	21,315,654	(7,782,757)
Cash and cash equivalents, beginning of period	20,844,640	24,119,157
Cash and cash equivalents, end of period	$ 42,160,294	$ 16,336,400
Supplemental cash flow information:		
Contingent stock consideration relating to acquisition of HInnovation, Inc. (see Note 9)	$ 3,083,627	$

(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, 2006 are not necessarily indicative of the results that may be expected for any subsequent quarter or for the year ending December 31, 2006. 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, 2005.

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 the periods indicated:

	For the three months ended September 30, 2006	2005	For the nine months ended September 30, 2006	2005
Toshiba Medical Systems Corporation	$ 7,636,000	$ 5,319,000	$ 20,302,000	$ 16,820,000
Percentage of total revenue	43 %	40 %	40 %	46 %
McKesson Information Systems LLC	$ 1,400,000	$ 1,280,000	$ 4,909,000	$ 2,735,000
Percentage of total revenue	8 %	10 %	10 %	8 %

As of September 30, 2006 and December 31, 2005, Toshiba Medical Systems Corporation accounted for 39% and 36% of accounts receivable, respectively. As of September 30, 2006 and December 31, 2005, McKesson Information Systems LLC accounted for 8% and 7% of accounts receivable, respectively.

Substantially all of the Company s export sales are negotiated, invoiced and paid in U.S. dollars. Export sales by geographic area are summarized as follows:

	For the three months ended September 30, 2006	2005	For the nine months ended September 30, 2006	2005
Europe	$ 1,711,000	$ 1,392,000	$ 4,360,000	$ 3,347,000
Asia and Pacific Region	486,000	592,000	1,627,000	1,723,000
Other Foreign Countries	753,000	445,000	2,010,000	1,018,000
Total	$ 2,950,000	$ 2,429,000	$ 7,997,000	$ 6,088,000
Percentage of total revenue	17 %	18 %	16 %	17 %

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 made to employees and directors, including employee stock options and employee stock purchases related to the Employee Stock Purchase Plan, based on estimated fair values. SFAS 123(R) supersedes the Company s previous accounting under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25), for periods beginning in 2006. In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 107 (SAB 107) relating to SFAS 123(R). The Company has applied the provisions of SAB 107 in its adoption of SFAS 123(R).

The Company adopted SFAS 123(R) using the modified prospective transition method, which requires the application of the accounting standard as of January 1, 2006. The Company s Condensed Consolidated Financial Statements as of and for the three and nine months ended September 30, 2006 reflect the impact of SFAS 123(R). In accordance with the modified prospective transition method, the Company s Condensed Consolidated Financial Statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123(R). Equity-based compensation expense recognized under SFAS 123(R) for the three and nine months ended September 30, 2006 was $1.3 million and $3.7 million, respectively. Equity-based compensation expense of $89,000 and $202,000 was recorded as expense for the three and nine months ended September 30, 2005 related to restricted stock awards, respectively. There were no equity-based compensation expenses related to employee stock options and employee stock purchases during the three and nine months ended September 30, 2005. Applying SFAS No. 123, Accounting for Stock-Based Compensation (SFAS 123), on a pro forma basis, equity-based compensation expense was $930,000 and $2.5 million for the three and nine months ended September 30, 2005.

The following table illustrates how equity-based compensation was allocated to the income statement as well as the effect on net income and net income per share of all equity-based compensation recognized under SFAS 123(R):

	Three Months Ended September 30, 2006	Nine Months Ended September 30, 2006
Cost of revenue	$ 98,066	$ 277,143
Sales and marketing	544,226	1,530,561
Research and development	155,875	638,876
General and administrative	486,257	1,278,851
Equity-based compensation before income taxes	1,284,424	3,725,431
Income tax benefit	(422,882)	(1,040,903)
Total equity-based compensation after income taxes	$ 861,542	$ 2,684,528
Impact on basic earnings per share	$ 0.06	$ 0.20
Impact on diluted earnings per share	$ 0.06	$ 0.19

The following table illustrates the effect on net income and net income per share as if we had applied the fair value recognition provisions of SFAS 123 to equity-based compensation during periods prior to January 1, 2006:

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	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2005
Net income, as reported	$ 1,621,386	$ 3,379,045
Add: Equity-based employee compensation expense included in reported net income, net of related tax effects	51,832	118,303
Deduct: Total equity-based employee compensation expense determined under fair value method for all awards, net of related tax effects	(586,947)	(1,506,811)
Pro forma net income	$ 1,086,271	$ 1,990,537
Net income per share - basic:		
As reported	$ 0.13	$ 0.27
Pro forma	$ 0.09	$ 0.16
Net income per share - diluted:		
As reported	$ 0.12	$ 0.26
Pro forma	$ 0.09	$ 0.16

SFAS 123(R) requires companies to estimate the fair value of equity-based payment awards on the date of grant using an option-pricing model. The Company uses the Black-Scholes option-pricing model, which requires the input of assumptions, including an estimate of the average period of time employees will retain vested stock options before exercising them, the estimated volatility of the Company s common stock price over the expected term and the number of options that will ultimately be forfeited before completing vesting requirements. Changes in the assumptions can materially affect the estimate of fair value of equity-based compensation and, consequently, the related expense recognized. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite vesting period. Prior to the adoption of SFAS 123(R), the Company accounted for equity-based awards to employees and directors using the intrinsic value method in accordance with APB 25 as allowed under SFAS 123.

Under the intrinsic value method, no equity-based compensation expense had been recognized related to employee stock options because the exercise price of the Company s stock options granted to employees and directors equaled the fair market value of the underlying stock at the date of grant.

Equity-based compensation expense recognized for the three and nine months ended September 30, 2006 included compensation expense for equity-based payment awards granted on or prior to December 31, 2005 but not yet vested as of that date. The compensation expense for these awards is based on the grant date fair value estimated in accordance with the pro forma provisions of SFAS 123, which was in effect on and prior to December 31, 2005. Compensation expense for the equity-based payment awards granted subsequent to December 31, 2005 is based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R). Because equity-based compensation expense recognized for the three and nine months ended September 30, 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. In the Company s pro forma information required under SFAS 123 for the periods prior to January 1, 2006, the Company accounted for forfeitures as they occurred.

Prior to the adoption of SFAS 123(R), the Company presented all tax benefits resulting from the exercise of stock options and settlement of restricted stock awards as operating cash inflows in the consolidated statements of cash flows in accordance with the provisions of the Emerging Issues Task Force (EITF) Issue No 00-15, Classification in the Statement of Cash Flows of the Income Tax Benefit Received by a Company upon Exercise of a Nonqualified Employee Stock Option. SFAS 123(R) requires the benefits of tax deductions in excess of the compensation cost recognized for those options and stock awards to be classified as financing cash inflows rather than operating cash inflows on a prospective basis. This amount is shown as Excess tax benefit from stock transactions on the Condensed Consolidated Statement of Cash Flows.

On November 10, 2005, the Financial Accounting Standards Board (FASB) issued FASB Staff Position No. FAS 123(R)-3, Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards (FSP No. FAS 123(R)-3). FSP No. FAS 123(R)-3 provides an alternative method of calculating the excess tax benefits available to absorb tax deficiencies recognized after the adoption of SFAS 123(R). The calculation of excess tax benefits reported as an operating cash outflow and a financing inflow in the Statement of Cash Flows required by FSP No. FAS 123(R)-3 differs from that required by SFAS 123(R). The Company has until December 2006 to make a one-time election to adopt the transition method described in FSP No. FAS 123(R)-3. The Company is currently evaluating FSP No. FAS 123(R)-3; however, the one-time election will not affect operating income or net income. During the interim period, the Company used the alternative method of calculating the excess tax benefits available after the adoption of SFAS 123(R).

Stock Options

In May 1997, Bio-Vascular, Inc., which is now known as Synovis Life Technologies, Inc., as the sole shareholder of the Company, approved and adopted the Vital Images, Inc. 1997 Stock Option and Incentive Plan (the Stock Option Plan), which became effective on May 12, 1997 (the Distribution Date). Under the terms of the Stock Option Plan, the Board of Directors or a committee of the Board may grant options and other equity-based awards to key employees to purchase shares of the Company s common stock at an option exercise price equal to or greater than 85% of the fair market value on the date of grant. The options are exercisable at such times, in installments or otherwise, as the Board of Directors or a committee of the Board may determine. Generally, these options have a term of five or eight years and are exercisable as to 28% of the total grant one year after the date of grant and 2% per month thereafter. The total number of shares of common stock that may be issued or awarded under the Stock Option Plan is 4,100,000 shares. As of September 30, 2006, there were 398,076 shares available for grant under the Stock Option Plan.

Also in May 1997, Bio-Vascular, as the sole shareholder of the Company, approved and adopted the Vital Images, Inc. 1997 Director Stock Option Plan (the Director Plan), which became effective on the Distribution Date. The Director Plan provides non-employee directors with automatic grants of stock options and allows the Board of Directors to make additional discretionary option grants to any or all directors. Options that are granted under the Director Plan are granted with an option price equal to the fair market value on the date of grant, have a term of five or eight years, are non-qualified options and become exercisable in three equal annual installments beginning on the first occurring December 31 after the date of grant. The total number of shares of common stock that may be issued or awarded under the Director Plan is 500,000 shares. As of September 30, 2006, there were 153,000 shares available for grant under the Director Plan.

On May 4, 2006, the shareholders of the Company approved the Vital Images, Inc. 2006 Long-Term Incentive Plan (the 2006 Plan). The 2006 Plan provides that the total number of shares of the Company s common stock that may be subject to options, restricted stock awards and other equity awards granted under the 2006 Plan shall not exceed 900,000 shares. The 2006 Plan provides the Board of Directors or a committee of the Board the authority to grant incentive stock options qualified as such under Section 422 of the Internal Revenue Code of 1986 and nonqualified stock options, awards of restricted stock, stock appreciation rights, other equity-based awards, cash-based awards or any combination of such awards subject to the terms of the 2006 Plan. As of September 30, 2006, there were 900,000 shares available for the grant of awards under the 2006 Plan.

The following table summarizes stock option activity for the nine months ended September 30, 2006: