

VITAL IMAGES INC
Form 10-Q
August 10, 2009
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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2009

OR

- 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)

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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 No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer
(Do not check if a smaller reporting company)

Smaller reporting company

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

On August 3, 2009, there were 14,238,409 shares of the Registrant's common stock, par value \$.01 per share, outstanding.

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**Vital Images, Inc.
Form 10-Q
June 30, 2009**

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Table of Contents**Part I. Financial Information****Item 1. Financial Statements****Vital Images, Inc.****Condensed Consolidated Balance Sheets****(In thousands, except per share amounts)
(Unaudited)**

| | June 30, 2009 | December 31, 2008 |
|---|------------------|----------------------|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 110,106 | \$ 109,706 |
| Marketable securities | 14,117 | 37,287 |
| Accounts receivable, net | 11,369 | 13,047 |
| Deferred income taxes | | 654 |
| Prepaid expenses and other current assets | 1,931 | 2,179 |
| Total current assets | 137,523 | 162,873 |
| Marketable securities | 16,879 | |
| Property and equipment, net | 7,251 | 11,519 |
| Deferred income taxes | | 13,904 |
| Other intangible assets, net | 562 | 808 |
| Goodwill | 9,089 | 9,089 |
| Total assets | \$ 171,304 | \$ 198,193 |
| Liabilities and Stockholders Equity | | |
| Current liabilities: | | |
| Accounts payable | \$ 2,364 | \$ 3,792 |
| Accrued compensation | 2,624 | 2,936 |
| Accrued royalties | 419 | 1,057 |
| Other current liabilities | 2,405 | 1,947 |
| Deferred revenue | 15,847 | 17,724 |
| Total current liabilities | 23,659 | 27,456 |
| Deferred revenue | 1,131 | 1,164 |
| Deferred rent | 676 | 882 |
| Total liabilities | 25,466 | 29,502 |
| Commitments and contingencies (Note 12) | | |
| 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; 14,259 issued and outstanding as of June 30, 2009; and 14,673 shares issued and outstanding as of December 31, 2008 | 143 | 147 |
| Additional paid-in capital | 165,805 | 168,738 |
| Accumulated deficit | (20,252) | (380) |
| Accumulated other comprehensive income | 142 | 186 |

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| | | | | |
|--|----|---------|----|---------|
| Total stockholders' equity | | 145,838 | | 168,691 |
| Total liabilities and stockholders' equity | \$ | 171,304 | \$ | 198,193 |

The accompanying notes are an integral part of the Condensed Consolidated Financial Statements.

Table of Contents**Vital Images, Inc.****Condensed Consolidated Statements of Operations****(In thousands, except per share amounts)
(Unaudited)**

| | For the Three Months Ended June 30, | | For the Six Months Ended June 30, | |
|---|--|-------------------|--------------------------------------|-------------------|
| | 2009 | 2008 | 2009 | 2008 |
| Revenue: | | | | |
| License fees | \$ 4,565 | \$ 7,706 | \$ 10,559 | \$ 17,064 |
| Maintenance and services | 8,371 | 7,811 | 16,932 | 15,345 |
| Hardware | 439 | 190 | 672 | 615 |
| Total revenue | 13,375 | 15,707 | 28,163 | 33,024 |
| Cost of revenue: | | | | |
| License fees | 558 | 1,011 | 1,528 | 2,164 |
| Maintenance and services | 2,268 | 2,479 | 4,645 | 5,051 |
| Hardware | 424 | 111 | 633 | 306 |
| Total cost of revenue | 3,250 | 3,601 | 6,806 | 7,521 |
| Gross profit | 10,125 | 12,106 | 21,357 | 25,503 |
| Operating expenses: | | | | |
| Sales and marketing | 6,040 | 8,117 | 11,995 | 16,168 |
| Research and development | 3,184 | 4,378 | 6,445 | 8,663 |
| General and administrative | 2,713 | 3,330 | 5,682 | 6,981 |
| Asset impairment | 3,147 | | 3,147 | |
| Total operating expenses | 15,084 | 15,825 | 27,269 | 31,812 |
| Operating loss | (4,959) | (3,719) | (5,912) | (6,309) |
| Interest income | 330 | 1,159 | 760 | 2,844 |
| Loss before income taxes | (4,629) | (2,560) | (5,152) | (3,465) |
| Provision (benefit) for income taxes | 14,992 | (983) | 14,720 | (1,294) |
| Net loss | \$ (19,621) | \$ (1,577) | \$ (19,872) | \$ (2,171) |
| Net loss per share basic and diluted | \$ (1.37) | \$ (0.09) | \$ (1.38) | \$ (0.13) |
| Weighted average common shares outstanding - basic and diluted | 14,288 | 16,827 | 14,402 | 16,951 |

The accompanying notes are an integral part of the Condensed Consolidated Financial Statements.

Table of Contents**Vital Images, Inc.****Condensed Consolidated Statements of Cash Flows****(In thousands)
(Unaudited)**

| | For the Six Months Ended June 30, | |
|--|--|-------------|
| | 2009 | 2008 |
| Cash flows from operating activities: | | |
| Net loss | \$ (19,872) | \$ (2,171) |
| Adjustments to reconcile net loss to net cash provided by operating activities: | | |
| Depreciation and amortization of property and equipment | 2,545 | 2,456 |
| Amortization of identified intangibles | 246 | 522 |
| Asset impairment | 3,147 | |
| Provision for doubtful accounts | 88 | 259 |
| Deferred income taxes | 14,664 | (1,294) |
| Excess tax benefit from stock transactions | | (157) |
| Amortization of discount and accretion of premium on marketable securities | 190 | (428) |
| Employee stock-based compensation | 1,974 | 2,542 |
| Amortization of deferred rent | (196) | (186) |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | 1,590 | 1,735 |
| Prepaid expenses and other assets | 248 | (137) |
| Accounts payable | (1,207) | 111 |
| Accrued expenses and other liabilities | (576) | 571 |
| Deferred revenue | (1,910) | 801 |
| Net cash provided by operating activities | 931 | 4,624 |
| Cash flows from investing activities: | | |
| Purchases of property and equipment | (1,645) | (2,792) |
| Purchases of marketable securities | (16,774) | (68,427) |
| Proceeds from maturities of marketable securities | 22,725 | 36,917 |
| Proceeds from sale of marketable securities | | 1,581 |
| Net cash provided by (used in) investing activities | 4,306 | (32,721) |
| Cash flows from financing activities: | | |
| Repurchases of common stock | (5,757) | (13,309) |
| Proceeds from sale of common stock under stock plans | 920 | 999 |
| Excess tax benefit from stock transactions | | 157 |
| Net cash used in financing activities | (4,837) | (12,153) |
| Net increase (decrease) in cash and cash equivalents | 400 | (40,250) |
| Cash and cash equivalents, beginning of period | 109,706 | 146,685 |
| Cash and cash equivalents, end of period | \$ 110,106 | \$ 106,435 |

The accompanying notes are an integral part of the Condensed Consolidated Financial Statements.

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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 six months ended June 30, 2009 are not necessarily indicative of the results that may be expected for any subsequent quarter or for the year ending December 31, 2009. The December 31, 2008 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, 2008.

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 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, resellers and independent distributors in the United States and international markets.

The Company has evaluated subsequent events through the date the financial statements were issued, August 10, 2009.

2. Significant customers and geographic data

Significant customer revenue (dollars in thousands):

| | For the Three Months Ended | | For the Six Months Ended | |
|-------------------------------------|----------------------------|----------|--------------------------|-----------|
| | June 30, | | June 30, | |
| | 2009 | 2008 | 2009 | 2008 |
| Toshiba Medical Systems Corporation | \$ 7,549 | \$ 7,883 | \$ 15,782 | \$ 16,666 |
| Percentage of total revenue | 56% | 50% | 56% | 50% |

As of June 30, 2009 and December 31, 2008, Toshiba Medical Systems Corporation (Toshiba) accounted for 52% and 42% of accounts receivable, respectively. As of June 30, 2009 and December 31, 2008, McKesson Information Systems LLC accounted for 10% and 7% of

accounts receivable, respectively.

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

| | For the Three Months Ended June 30, | | For the Six Months Ended June 30, | |
|---|--|-----------|--------------------------------------|-----------|
| | 2009 | 2008 | 2009 | 2008 |
| United States | \$ 8,995 | \$ 11,987 | \$ 18,679 | \$ 25,211 |
| Europe | 2,352 | 1,921 | 5,015 | 3,960 |
| Asia and Pacific | 795 | 924 | 2,143 | 1,949 |
| Other foreign | 1,233 | 875 | 2,326 | 1,904 |
| Total | \$ 13,375 | \$ 15,707 | \$ 28,163 | \$ 33,024 |
| Export revenue as a percent of total revenue | 33% | 24% | 34% | 24% |

The Company's export sales are primarily negotiated, invoiced and paid in U.S. dollars, with a portion of sales transactions denominated in foreign currencies.

3. Research and development

In January 2009, the Company and Toshiba entered into a co-development and collaboration agreement in which the two companies will enter into a mutual license of intellectual property and will jointly invest to develop and deliver innovative technology advancements for Toshiba's medical equipment and the Company's advanced visualization software solutions. The Company accounts for the agreement under the provisions of Emerging Issues Task Force (EITF) Issue No. 07-1, Accounting for Collaborative Arrangements (EITF 07-1). The Company's policy is to recognize payments received under the agreement as an offset to research and development expense in the period in which the related costs are incurred. During the three and six months ended June 30, 2009, the Company received payments of \$455,000 and \$1,024,000, respectively, and recognized credits of \$262,000 and \$505,000, respectively, to its research and development expense for reimbursement from Toshiba to offset the development costs the Company incurred during the respective periods under the agreement. The remaining unrecognized balance of \$519,000 was included in other current liabilities as of June 30, 2009 and will be recognized as a credit to research and development expense in future periods as the development costs are incurred.

4. Asset impairment

In 2007, the Company began the implementation of an enterprise resource planning (ERP) system. The ERP system was intended to replace numerous disconnected business management software applications and link the data contained within these disconnected systems to enable better management of the Company's business and derive more useful data for various business functions, such as sales, marketing, finance and customer support.

Phase 1 of the implementation, which related to the replacement of the Company's general ledger, was completed in 2007. The related capitalized costs are being depreciated over seven years and, as of June 30, 2009, the net book value of Phase 1 was \$693,000. Phase 2 of the implementation, which consisted of replacing the Company's various customer relationship management and order processing systems, has not been implemented to date and was put on hold in 2008 in conjunction with the Company's cost-control efforts, and the Company has not

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capitalized any costs relating to Phase 2 since that time. In conjunction with continuing cost-control measures, the Company determined that it would not implement Phase 2 at this time. As a result, the Company recognized an asset impairment charge of \$3.1 million related to the Phase 2 implementation.

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

| | For the Three Months Ended June 30, | | | | For the Six Months Ended June 30, | | | |
|---|--|----------|----------|----------|--------------------------------------|------|------|------|
| | 2009 | 2008 | 2009 | 2008 | 2009 | 2008 | 2009 | 2008 |
| Cost of revenue | \$ 81 | \$ 88 | \$ 161 | \$ 164 | | | | |
| Sales and marketing | 341 | 364 | 683 | 732 | | | | |
| Research and development | 197 | 288 | 392 | 553 | | | | |
| General and administrative | 363 | 570 | 738 | 1,093 | | | | |
| Total equity-based compensation expense | \$ 982 | \$ 1,310 | \$ 1,974 | \$ 2,542 | | | | |

As of June 30, 2009, approximately \$6.6 million of unrecognized compensation expense related to stock options was expected to be recognized over a weighted-average period of 2.9 years. As of June 30, 2009, approximately \$428,000 of unrecognized compensation expense related to restricted stock awards was expected to be recognized over a weighted-average period of 2.7 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 include the expected stock volatility, the risk-free interest rate, the option's expected life and the dividend yield on the underlying stock.

For purposes of calculating the fair value of options under Statement of Financial Accounting Standard (SFAS) No. 123(R), Share-Based Payment, the weighted-average fair value of options granted was \$3.94 and \$3.44 for the three and six months ended June 30, 2009 and \$5.81 and \$5.68 for the three and six months ended June 30, 2008, 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 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 June 30, | | For the Six Months Ended June 30, | |
|----------------------------|--|------------|--------------------------------------|------------|
| | 2009 | 2008 | 2009 | 2008 |
| Expected option life | 3.26 years | 3.75 years | 3.67 years | 3.75 years |
| Expected volatility factor | 49% | 45% | 48% | 46% |
| Expected dividend yield | 0% | 0% | 0% | 0% |
| Risk-free interest rate | 1.48% | 3.00% | 1.56% | 2.40% |
| Expected forfeiture rate | 2% | 2% | 2% | 1% |

The following table summarizes stock option activity for the six months ended June 30, 2009:

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**Shares Underlying
Options**

| | |
|---|-----------|
| Total outstanding as of December 31, 2008 | 2,452,859 |
| Options granted | 437,420 |
| Options exercised | (96,808) |
| Options cancelled | (167,982) |
| Total outstanding as of June 30, 2009 | 2,625,489 |

Options granted during the three and six months ended June 30, 2009 primarily consisted of the Company's annual grant to employees in the first quarter of 2009.

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In the first quarter of 2007, the Company granted shares of restricted stock with performance-based vesting to certain employees. No equity-based compensation expense for the awards was recognized for the three and six months ended June 30, 2009, as the Company did not consider achievement of the performance metrics to be probable. The cumulative amount of the expense related to these awards not recognized as of June 30, 2009 but that may be recognized in future periods if performance metrics are met was \$177,000.

6. Per share data

Basic net loss per share is computed using net loss and the weighted-average number of common shares outstanding. Diluted net loss 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.

For the three and six months ended June 30, 2009 and 2008, common share equivalents are not included in the diluted net loss per share calculations because they were antidilutive. Shares subject to antidilutive stock options and restricted stock awards excluded from net loss per share totaled 2.7 million for the three and six months ended June 30, 2009 and 2.6 million for the three and six months ended June 30, 2008.

7. Comprehensive income (loss)

Comprehensive income (loss), as defined by SFAS No. 130, Reporting Comprehensive Income (SFAS No. 130), includes net income (loss) and items defined as other comprehensive income. SFAS No. 130 requires that items defined as other comprehensive income (loss), 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 (loss).

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

| | For the Three Months Ended June 30, | | For the Six Months Ended June 30, | |
|---|--|------------|--------------------------------------|------------|
| | 2009 | 2008 | 2009 | 2008 |
| Net loss | \$ (19,621) | \$ (1,577) | \$ (19,872) | \$ (2,171) |
| Other comprehensive income (loss): | | | | |
| Net change in unrealized gain or loss on available-for-sale investments, net of tax | 42 | (88) | (44) | (57) |
| Comprehensive loss | \$ (19,579) | \$ (1,665) | \$ (19,916) | \$ (2,228) |

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The following table provides the assets and liabilities carried at fair value measured on a recurring basis in accordance with SFAS No. 157, Fair Value Measurements, as of June 30, 2009 (in thousands):

| | Total Carrying Value at June 30, 2009 | Fair Value Measurements at June 30, 2009 Using | | |
|--|---------------------------------------|--|---|---|
| | | Quoted price in active markets (Level 1) | Significant other observable inputs (Level 2) | Significant unobservable inputs (Level 3) |
| Cash equivalents: | | | | |
| Money market | \$ 104,853 | \$ 104,853 | \$ | \$ |
| Marketable securities: | | | | |
| Corporate debt | 16,982 | 16,879 | 103 | |
| Government debt | 14,014 | 14,014 | | |
| Total marketable securities | 30,996 | 30,893 | 103 | |
| Total cash equivalents and marketable securities | \$ 135,849 | \$ 135,746 | \$ 103 | \$ |

Cash equivalents and marketable securities measured at fair value using quoted market prices are classified within Level 1 of the valuation hierarchy.

Marketable securities classified within Level 2 of the valuation hierarchy consist of an asset-backed security. The valuation of this asset-backed security is determined by reviewing quoted market prices for traded lots of the same or similar securities. This security is rated AAA and is current on scheduled pay-downs, with expected full maturity within the next 12 months. The Company did not consider this investment to be other than temporarily impaired as of June 30, 2009.

9. Other intangible assets

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

| | June 30, 2009 | | | December 31, 2008 | | |
|---|----------------------|--------------------------|--------------------|----------------------|--------------------------|--------------------|
| | Gross Carrying Value | Accumulated Amortization | Net Carrying Value | Gross Carrying Value | Accumulated Amortization | Net Carrying Value |
| Existing software technology | \$ 3,400 | \$ (3,400) | \$ | \$ 3,400 | \$ (3,334) | \$ 66 |
| Patents and patent applications | 2,500 | (1,938) | 562 | 2,500 | (1,758) | 742 |
| Total intangible assets subject to amortization | \$ 5,900 | \$ (5,338) | \$ 562 | \$ 5,900 | \$ (5,092) | \$ 808 |

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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 \$90,000 and \$261,000 for the three months ended June 30, 2009 and 2008, respectively, and \$246,000 and \$522,000 for the six months ended June 30, 2009 and 2008, respectively. As of June 30, 2009, fully amortized existing software technology was still in use.

The estimated future amortization expense for identified intangible assets as of June 30, 2009 is as follows (in thousands):

| | | |
|-------------------|----|-----|
| Remainder of 2009 | \$ | 180 |
| 2010 | | 360 |
| 2011 | | 22 |
| Total | \$ | 562 |

The preceding expected amortization expense is an estimate. Actual amortization expense may differ from estimates due to any additional intangible asset acquisitions, impairment of intangible assets, accelerated amortization of

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intangible assets and other events. A patent acquired in the HInnovation, Inc. acquisition having a net book value of \$450,000 as of June 30, 2009 is currently under review by the United States Patent and Trademark Office.

10. Deferred revenue

The components of deferred revenue were as follows:

| | June 30, 2009 | December 31, 2008 |
|---------------------------------------|------------------|----------------------|
| Maintenance and support | \$ 13,352 | \$ 13,912 |
| Customer education | 2,232 | 3,034 |
| Professional services | 626 | 788 |
| Software | 365 | 616 |
| Hardware and other | 403 | 538 |
| Total deferred revenue | 16,978 | 18,888 |
| Less current portion | (15,847) | (17,724) |
| Long-term portion of deferred revenue | \$ 1,131 | \$ 1,164 |

11. Income taxes

Companies are required to assess whether a valuation allowance should be recorded against their deferred tax assets based on the consideration of all available evidence, using a more likely than not realization standard. The four sources of taxable income that must be considered in determining whether deferred tax assets will be realized are: 1) future reversals of existing taxable temporary differences; 2) future taxable income exclusive of reversing temporary differences and carryforwards; 3) taxable income in prior carryback years if carryback is permitted under the tax law; and 4) tax planning strategies.

The Company has evaluated its deferred tax assets each reporting period, including making an assessment of cumulative pretax results in recent years and projections of cumulative pretax results in future periods. As a general guideline, the Company considered the cumulative pretax results from the most recent three years. A significant negative factor in the Company's assessment at June 30, 2009 was that the Company will transition to a three-year historical cumulative pretax loss during 2009, as highly profitable quarters in 2006 are removed from the cumulative three-year pretax results. In addition, uncertain near-term market and economic conditions reduced the Company's ability to rely on projections of future taxable income in assessing the realization of the Company's deferred tax assets. As a result, during the three months ended June 30, 2009, the Company recorded a non-cash charge of \$15.0 million to the provision for income taxes to establish a full valuation allowance against its deferred tax assets. If pretax results improve in future periods, the Company may be able to utilize the deferred tax assets to reduce tax payments.

12. Commitments and contingencies

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Under general contract terms, the Company often includes provisions in its software license agreements under which the Company agrees to indemnify 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.

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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 the Company's future results of operations or cash flows.

13. Share repurchase programs

During 2008, the Company's Board of Directors approved a share repurchase program, which authorized open market transactions of up to \$40.0 million, including fees and expenses, of the Company's common stock. The program authorized management to repurchase shares from time to time, depending on market conditions. During the first quarter of 2009, the Company purchased 149,000 shares for \$1.8 million under the program. The Company completed the \$40.0 million share repurchase program on February 6, 2009, having repurchased an aggregate of 2.9 million shares under the program.

On March 3, 2009, the Company announced an additional share repurchase program, authorizing up to an additional 1.0 million shares to be repurchased on the open market. The Company completed stock repurchases under this program of 236,000 shares for \$2.5 million during the three months ended June 30, 2009 and 382,000 shares for \$4.0 million during the six months ended June 30, 2009, inclusive of fees and expenses. Subsequent to June 30, 2009 and through August 7, 2009, the Company had purchased 30,000 shares under the program, bringing the total aggregate shares repurchased under this additional share repurchase program to 412,000 shares.

At the time of repurchase, shares are returned to the status of authorized and unissued shares. The Company has accounted for the repurchases as constructively retired and recorded such repurchases as a reduction of common stock and additional paid-in capital.

14. New accounting pronouncements

In June 2009, the FASB issued SFAS No. 168, *The FASB Accounting Standards Codification™* and the Hierarchy of Generally Accepted Accounting Principles a replacement of FASB Statement No. 162 (SFAS No. 160) under SFAS No. 160, *The FASB Accounting Standards Codification* (Codification) will become the source of authoritative U.S. generally accepted accounting principles (GAAP) recognized by the FASB to be applied by nongovernmental entities. Rules and interpretive releases of the Securities and Exchange Commission (SEC) under authority of federal securities laws are also sources of authoritative GAAP for SEC registrants. On the effective date of SFAS No. 160, the Codification will supersede all then-existing non-SEC accounting and reporting standards. All other non-grandfathered non-SEC accounting literature not included in the Codification will become non-authoritative. This Statement is effective for financial statements issued for interim and annual periods ending after September 15, 2009. In the FASB's view, the issuance of this Statement and the Codification will not change GAAP, except for those nonpublic nongovernmental entities that must now apply the American Institute of Certified Public Accountants Technical Inquiry Service Section 5100, Revenue Recognition, paragraphs 38-76. The Company does not expect that the adoption of SFAS No. 160 will have a material impact on the Company's consolidated financial statements.

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

Executive summary

The financial results for Vital Images, Inc. (also referred to as we, us and our) have continued to be affected by the general decline in the U.S. economy, which has resulted in contracted capital spending by U.S. hospitals and lower interest rates on our cash and investments. Additionally, we have been impacted by weakness in the high-end computed tomography, or CT, and picture archiving and communication systems, or PACS, markets and the impact of the Deficit Reduction Act of 2005.

Revenue decreased for the second quarter of 2009, compared to the same period in 2008, reflecting the markets' continued weakness. Sales and marketing, research and development, and general and administrative expenses for the 2009 second quarter decreased as we experienced lower compensation costs, compared to the same period in 2008, resulting primarily from our 11% workforce reduction in November 2008. Other cost-control measures also contributed to decreases in operating expense categories during the 2009 second quarter, compared to the same period in 2008.

- Revenue for the 2009 second quarter decreased 15% to \$13.4 million, compared to \$15.7 million for the second quarter of 2008.
- Gross margin was 76%, compared to 77% for the second quarter of 2008.
- Loss before income taxes was \$(4.6) million, compared to \$(2.6) million for the second quarter of 2008.
- Net loss was \$(19.6) million, or \$(1.37) per diluted share, compared to \$(1.6) million, or \$(0.09) per diluted share, for the second quarter of 2008.
- Second quarter non-cash charges of \$18.1 million for the second quarter of 2009 consisted of a \$15.0 million valuation allowance against our deferred tax assets, and a \$3.1 million write-off relating to the unimplemented portion of our enterprise resource planning system as a result of our cost-control efforts.

Revenue decreased for the six months ended June 30, 2009, compared to the same period in 2008, reflecting the markets' continued weakness. Sales and marketing, research and development, and general and administrative expenses for the six months ended June 30, 2009 decreased as we experienced lower compensation costs, compared to the same period in 2008, resulting primarily from our 11% workforce reduction in November 2008. Other cost-control measures also contributed to decreases in operating expense categories during the six months ended June 30, 2009, compared to the same period in 2008.

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- Revenue decreased 15% to \$28.2 million, compared to \$33.0 million for the first six months of 2008.
- Gross margin was 76%, compared to 77% for the first six months of 2008.
- Loss before income taxes was \$(5.2) million, compared to \$(3.5) million for the first six months of 2008.
- Net loss was \$(19.9) million, or \$(1.38) per diluted share, compared to \$(2.2) million, or \$(0.13) per diluted share, for the first six months of 2008.
- Non-cash charges totaling \$18.1 million for the first six months of 2009 consisted of a \$15.0 million valuation allowance against our deferred tax assets and a \$3.1 million write-off relating to the unimplemented portion of our enterprise resource planning system as a result of our cost-control efforts.

Total cash, cash equivalents and marketable securities were \$141.1 million as of June 30, 2009, compared to \$144.9 million as of March 31, 2009 and \$147.0 million as of December 31, 2008. Working capital (defined as current assets less current liabilities) was \$113.9 million as of June 30, 2009, a decrease from \$121.3 million as of March 31, 2009 and \$135.4 million as of December 31, 2008. The decrease in cash, cash equivalents and marketable

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securities during the three and six months ended June 30, 2009 was primarily the result of repurchases of our common stock totaling \$2.5 million and \$5.8 million, respectively, under our share repurchase programs. The decrease in working capital was also due to purchases of noncurrent marketable securities totaling \$4.9 million and \$16.8 million, respectively.

Overview

We are a leading provider of advanced visualization and analysis solutions for use by medical professionals in clinical analysis and therapy planning. We provide software, customer education, software maintenance and support, 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 the cost, quality and accessibility of health care by improving physician workflow and productivity, enhancing the ability to make clinical decisions, facilitating less invasive patient care, and complementing 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 CT 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.

We operate and manage our business as a single business segment – the development and marketing of software and related services for 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.

ViTAL Enterprise, introduced in May 2008, enables unlimited enterprise access to the complete ViTAL solution offering, including *Vitrea*, *Vitrea Web*, *ViTALConnect* and our specialized clinical options. *ViTAL Enterprise* provides customers with full access to our clinical solutions and comprehensive services, including education, consulting and maintenance. *ViTAL Enterprise* has the flexibility to scale to the size of the customer's enterprise by providing access to the complete ViTAL solution based on unlimited users or concurrent users. Additionally, *ViTAL Enterprise* offers customers the ability to license the solution through capital or subscription pricing, and it is available to our worldwide installed base of existing customers. We anticipate an increasing percentage of license fee revenue will be from sales of *ViTAL Enterprise*.

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 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.

Vitrea Web provides users with everywhere access to Vital Images' powerful advanced clinical applications via the Web. With *Vitrea Web*, customers have the same capabilities of a standalone workstation to review, analyze and communicate findings, all from any PC that has Web access. *Vitrea Web* enables advanced best of breed clinical applications access throughout the healthcare enterprise.

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ViTALConnect® software allows multiple physicians to collaboratively use advanced visualization in their medical practices. It provides radiologists and referring physicians anywhere, anytime access via the Web 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

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reformat, or MPR, modes, thick slab rendering in MPR, 3D volumetric visualization with simple point of interest navigation, 4D dataset visualization, CT/positron emission tomography, or PET, fusion and advanced analysis tools.

Advanced visualization options 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 *Vitre*a software according to their unique requirements. Most options are proprietary; however, *Vitre*a also serves as an integration platform for applications offered by our visualization technology partners. Our options include:

| Option | Clinical Use |
|-------------------------------------|---|
| •Vscore | Quantifies calcium in the four major coronary arteries |
| •CT Brain Perfusion | Analyzes the blood flow of stroke victims |
| •Innerview GI (virtual colonoscopy) | Locates and analyzes polyps in the colon |
| •Automated Vessel Measurements | Characterizes the course and dimensions of diseased blood vessels |
| •CT Cardiac | Determines the extent of obstructive coronary artery disease |
| •SUREPlaque | Aids in evaluating, characterizing and quantifying plaque inside the coronary arteries |
| •Vessel Probe | Defines vascular anatomy and the extent of obstruction in vessels other than the coronary arteries |
| •CT Lung and Lung Tools | Visualizes and measures nodules in the lungs |
| •ImageChecker® CT | Detects pulmonary nodules in the chest |
| •Fusion7D | Visualizes images and fuse studies from multiple modalities, such as magnetic resonance, or MR, and PET |
| •CADstream | Analyzes MR breast exams |
| •QMass MR | Analyzes MR cardiac images |
| •EP Planning | 3D advanced visualization and modeling tool for the electrophysiology lab |
| •Collaboration | Enables two users to collaborate while viewing the same study at the same time |
| •PET/CT Overlay | Provides the ability to overlay PET and CT images with Standardized Uptake Value (SUV) calculations |

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 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. 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, which sell our products with other products they either manufacture or acquire from third parties.

Our products work with equipment from all major manufacturers of diagnostic imaging systems, including Toshiba Medical Systems Corporation (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 Corporation and Sectra AB, and run on off-the-shelf third-party computer hardware.

Critical accounting policies and estimates

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

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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, 2008. The preparation of

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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 Item 7. 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, 2008. The adoption of Emerging Issues Task Force (EITF) Issue No. 07-1,

Accounting for Collaborative Arrangements and its application to our collaborative arrangement with Toshiba was the only significant new accounting policy during the six months ended June 30, 2009.

Results of Operations

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

| | For the Three Months Ended | | For the Six Months Ended | |
|--------------------------------------|----------------------------|------------------|--------------------------|------------------|
| | 2009 | June 30, 2008 | 2009 | June 30, 2008 |
| Revenue: | | | | |
| License fees | 34.1% | 49.1% | 37.5% | 51.7% |
| Maintenance and services | 62.6 | 49.7 | 60.1 | 46.5 |
| Hardware | 3.3 | 1.2 | 2.4 | 1.8 |
| Total revenue | 100.0 | 100.0 | 100.0 | 100.0 |
| Cost of revenue: | | | | |
| License fees | 4.2 | 6.4 | 5.4 | 6.6 |
| Maintenance and services | 16.9 | 15.8 | 16.5 | 15.3 |
| Hardware | 3.2 | 0.7 | 2.3 | 0.9 |
| Total cost of revenue | 24.3 | 22.9 | 24.2 | 22.8 |
| Gross profit | 75.7 | 77.1 | 75.8 | 77.2 |
| Operating expenses: | | | | |
| Sales and marketing | 45.2 | 51.7 | 42.6 | 49.0 |
| Research and development | 23.8 | 27.9 | 22.9 | 26.2 |
| General and administrative | 20.3 | 21.2 | 20.1 | 21.1 |
| Asset impairment | 23.5 | | 11.2 | |
| Total operating expenses | 112.8 | 100.8 | 96.8 | 96.3 |
| Operating loss | (37.1) | (23.7) | (21.0) | (19.1) |
| Interest income | 2.5 | 7.4 | 2.7 | 8.6 |
| Loss before income taxes | (34.6) | (16.3) | (18.3) | (10.5) |
| Provision (benefit) for income taxes | 112.1 | (6.3) | 52.3 | (3.9) |
| Net loss | (146.7)% | (10.0)% | (70.6)% | (6.6)% |

Table of Contents**Revenue**

A comparison of revenue by category is as follows (dollars in thousands):

| | For the Three Months Ended | | | | For the Six Months Ended | | | |
|--------------------------|----------------------------|-----------|-----------------|-------|--------------------------|-----------|-----------------|-------|
| | 2009 | 2008 | June 30, Change | | 2009 | 2008 | June 30, Change | |
| Revenue: | | | | | | | | |
| License fees | \$ 4,565 | \$ 7,706 | \$ (3,141) | (41)% | \$ 10,559 | \$ 17,064 | \$ (6,505) | (38)% |
| Maintenance and services | 8,371 | 7,811 | 560 | 7% | 16,932 | 15,345 | 1,587 | 10% |
| Hardware | 439 | 190 | 249 | 131% | 672 | 615 | 57 | 9% |
| Total revenue | \$ 13,375 | \$ 15,707 | \$ (2,332) | (15)% | \$ 28,163 | \$ 33,024 | \$ (4,861) | (15)% |

License fee revenue (dollars in thousands)

| | For the Three Months Ended | | | | For the Six Months Ended | | | |
|---|----------------------------|----------|-----------------|--------|--------------------------|-----------|-----------------|-------|
| | 2009 | 2008 | June 30, Change | | 2009 | 2008 | June 30, Change | |
| License fee revenue: | | | | | | | | |
| VitreA licenses | \$ 1,348 | \$ 2,134 | \$ (786) | (37)% | \$ 2,923 | \$ 5,154 | \$ (2,231) | (43)% |
| VitreA options and third party software | 2,650 | 4,724 | (2,074) | (44)% | 6,048 | 10,619 | (4,571) | (43)% |
| ViTAL Enterprise | 567 | 453 | 114 | 25% | 1,137 | 453 | 684 | 151% |
| ViTALConnect | | 395 | (395) | (100)% | 451 | 838 | (387) | (46)% |
| Total license fee revenue | \$ 4,565 | \$ 7,706 | \$ (3,141) | (41)% | \$ 10,559 | \$ 17,064 | \$ (6,505) | (38)% |

ViTAL Enterprise, introduced in May 2008, enables unlimited enterprise access to the complete ViTAL solution offering, including *VitreA*, *ViTALConnect* and our specialized clinical options. We expect revenue from sales of *ViTAL Enterprise* will become a larger portion of our total license revenue, which will cause revenue from sales of individual *VitreA* licenses, *VitreA* options and third party software to continue to decrease in significance. The decrease in license fee revenue during the three and six months ended June 30, 2009, compared to the same periods in 2008, was driven primarily by continued pressure on hospital capital spending in the U.S., which was partially offset by growth in our international license fee revenue, primarily in Europe and Latin America.

The following table sets forth information on license fee revenue by source (dollars in thousands):

| | For the Three Months Ended | | | | For the Six Months Ended | | | |
|-------------------------------|----------------------------|----------|-----------------|-------|--------------------------|----------|-----------------|-------|
| | 2009 | 2008 | June 30, Change | | 2009 | 2008 | June 30, Change | |
| License fee revenue: | | | | | | | | |
| Direct and other distributors | \$ 345 | \$ 2,650 | \$ (2,305) | (87)% | \$ 1,705 | \$ 5,847 | \$ (4,142) | (71)% |

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| | | | | | | | | |
|---------------------------------|----------|----------|------------|-------|-----------|-----------|------------|-------|
| Toshiba | 4,220 | 5,056 | (836) | (17)% | 8,854 | 11,217 | (2,363) | (21)% |
| Total license fee revenue | \$ 4,565 | \$ 7,706 | \$ (3,141) | (41)% | \$ 10,559 | \$ 17,064 | \$ (6,505) | (38)% |
| Percent of license fee revenue: | | | | | | | | |
| Direct and other distributors | 8% | 34% | | | 16% | 34% | | |
| Toshiba | 92% | 66% | | | 84% | 66% | | |
| Total license fee revenue | 100% | 100% | | | 100% | 100% | | |

Table of Contents**Maintenance and services revenue (dollars in thousands)**

| | For the Three Months Ended | | | | For the Six Months Ended | | | |
|-----------------------------------|----------------------------|----------|----------|-------|--------------------------|-----------|----------|-------|
| | 2009 | 2008 | June 30, | | 2009 | 2008 | June 30, | |
| | | | Change | | | | Change | |
| Maintenance and services revenue: | | | | | | | | |
| Maintenance and support | \$ 7,089 | \$ 6,356 | \$ 733 | 12% | \$ 14,460 | \$ 12,473 | \$ 1,987 | 16% |
| Customer education | 946 | 1,201 | (255) | (21)% | 1,901 | 2,255 | (354) | (16)% |
| Professional services | 336 | 254 | 82 | 32% | 571 | 617 | (46) | (7)% |
| Total maintenance and services | \$ 8,371 | \$ 7,811 | \$ 560 | 7% | \$ 16,932 | \$ 15,345 | \$ 1,587 | 10% |

The increase in maintenance and support revenue for the three and six months ended June 30, 2009, compared to the same periods in 2008, was due to an increase in the number of customers on maintenance contracts both from new license sales and increased maintenance contract capture rates. The decrease in customer education revenue for the three and six months ended June 30, 2009, compared to the same periods in 2008, was due to the general timing of training sessions and the effect of decreased license sales. Professional services revenue increased for the three months ended June 30, 2009, compared to the same period in 2008, due to the timing of services provided. Professional services revenue decreased for the six months ended June 30, 2009, compared to the same period in 2008, due to the amount and timing of installations and the effect of decreased license sales.

Hardware revenue

Hardware revenue increased 131% to \$439,000 during the second quarter of 2009, compared to \$190,000 during the second quarter of 2008, and increased 9% to \$672,000 during the first six months of 2009, compared to \$615,000 for the same period in 2008. We offer to sell hardware to our customers in conjunction with license sales, and fluctuations 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 and preferences 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 Six Months Ended | | | |
|--------------------------|----------------------------|----------|------------|-------|--------------------------|-----------|------------|-------|
| | 2009 | 2008 | June 30, | | 2009 | 2008 | June 30, | |
| | | | Change | | | | Change | |
| Gross profit: | | | | | | | | |
| License fees | \$ 4,007 | \$ 6,695 | \$ (2,688) | (40)% | \$ 9,031 | \$ 14,900 | \$ (5,869) | (39)% |
| Maintenance and services | 6,103 | 5,332 | 771 | 14% | 12,287 | 10,294 | 1,993 | 19% |
| Hardware | 15 | 79 | (64) | (81)% | 39 | 309 | (270) | (87)% |

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| | | | | | | | | |
|--------------------------|-----------|-----------|------------|-------|-----------|-----------|------------|-------|
| Total gross profit | \$ 10,125 | \$ 12,106 | \$ (1,981) | (16)% | \$ 21,357 | \$ 25,503 | \$ (4,146) | (16)% |
| Gross margin: | | | | | | | | |
| License fees | 88% | 87% | | | 86% | 87% | | |
| Maintenance and services | 73% | 68% | | | 73% | 67% | | |
| Hardware | 3% | 41% | | | 6% | 50% | | |
| Total gross margin | 76% | 77% | | | 76% | 77% | | |

License fee gross margins for the three and six months ended June 30, 3009 were consistent with the same periods in 2009. Factors affecting gross margin for the three and six months ended June 30, 2009, compared to the same periods in 2008, included decreased amortization expense and changes in sales mix, which positively impacted gross margin, and increased pricing pressure in a difficult market, which negatively impacted gross margin. For the three and six months ended June 30, 2009, amortization expense included in license fee cost of revenue decreased \$171,000 and \$276,000, respectively, compared to the same periods in 2008, due to an intangible asset becoming fully amortized.

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Maintenance and services gross margins increased for the three and six months ended June 30, 2009, compared to the same periods in 2008, due to increased pricing on *ViTAL Enterprise* maintenance and services. The increase in gross margin for the six months ended June 30, 2009 was also impacted by a \$552,000 benefit to maintenance and support revenue in the first quarter of 2009 arising from Toshiba billing adjustments relating to historic periods.

Hardware gross margins decreased for the three and six months ended June 30, 2009, compared to the same periods in 2008, due to variability in pricing during the periods.

Operating expenses

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

| | Percent of Revenue for the Three Months | | Percent Change for the Three Months Ended June 30, 2008 to 2009 | Percent of Revenue for the Six Months | | Percent Change for the Six Months Ended June 30, 2008 to 2009 |
|----------------------------|--|--------|---|--|-------|---|
| | 2009 | 2008 | | 2009 | 2008 | |
| Operating expenses: | | | | | | |
| Sales and marketing | 45.2% | 51.7% | (26)% | 42.6% | 49.0% | (26)% |
| Research and development | 23.8 | 27.9 | (27)% | 22.9 | 26.2 | (26)% |
| General and administrative | 20.3 | 21.2 | (19)% | 20.1 | 21.2 | (19)% |
| Asset impairment | 23.5 | | 100% | 11.2 | | 100% |
| Total operating expenses | 112.8% | 100.8% | (5)% | 96.8% | 96.4% | (14)% |

Sales and marketing

Sales and marketing expenses are as follows (dollars in thousands):

| | For the Three Months Ended June 30, | | | |
|---------------------------------|-------------------------------------|----------|------------|-------|
| | 2009 | 2008 | Change | |
| Salaries, benefits and bonuses | \$ 2,493 | \$ 3,379 | \$ (886) | (26)% |
| Overhead and other expenses | 995 | 1,282 | (287) | (22)% |
| Travel, meals and entertainment | 697 | 1,015 | (318) | (31)% |
| Trade shows and advertising | 640 | 757 | (117) | (15)% |
| Commissions | 432 | 932 | (500) | (54)% |
| Depreciation | 442 | 388 | 54 | 14% |
| Equity-based compensation | 341 | 364 | (23) | (6)% |
| Total | \$ 6,040 | \$ 8,117 | \$ (2,077) | (26)% |

For the Six Months Ended June 30,

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| | 2009 | 2008 | Change | |
|---------------------------------|-----------|-----------|------------|-------|
| Salaries, benefits and bonuses | \$ 5,089 | \$ 6,818 | \$ (1,729) | (25)% |
| Overhead and other expenses | 1,813 | 2,266 | (453) | (20)% |
| Travel, meals and entertainment | 1,339 | 1,841 | (502) | (27)% |
| Trade shows and advertising | 1,230 | 1,576 | (346) | (22)% |
| Commissions | 928 | 2,128 | (1,200) | (56)% |
| Depreciation | 913 | 807 | 106 | 13% |
| Equity-based compensation | 683 | 732 | (49) | (7)% |
| Total | \$ 11,995 | \$ 16,168 | \$ (4,173) | (26)% |

The decrease in salaries and benefits costs for the three and six months ended June 30, 2009, compared to the three and six months ended June 30, 2008, resulted from decreased headcount, primarily from our 11% reduction in

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workforce in November 2008. The decrease in commissions expense for the three and six months ended June 30, 2009, compared to the same periods in 2008, was due to decreased direct sales. The decrease in other expense categories for the three and six months ended June 30, 2009 was primarily due to decreased headcount and other broad-based cost control measures. We had 82 and 95 sales and marketing personnel as of June 30, 2009 and 2008, respectively.

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

Research and development

Research and development expenses are as follows (dollars in thousands):

| | For the Three Months Ended June 30, | | | |
|--------------------------------|--|-----------------|-------------------|--------------|
| | 2009 | 2008 | Change | |
| Salaries, benefits and bonuses | \$ 2,391 | \$ 2,801 | \$ (410) | (15)% |
| Overhead and other expenses | 653 | 737 | (84) | (11)% |
| Depreciation | 191 | 228 | (37) | (16)% |
| Equity-based compensation | 197 | 288 | (91) | (32)% |
| Consulting | 14 | 324 | (310) | (96)% |
| Development reimbursement | (262) | | (262) | 100% |
| Total | \$ 3,184 | \$ 4,378 | \$ (1,194) | (27)% |

| | For the Six Months Ended June 30, | | | |
|--------------------------------|--|-----------------|-------------------|--------------|
| | 2009 | 2008 | Change | |
| Salaries, benefits and bonuses | \$ 4,833 | \$ 5,640 | \$ (807) | (14)% |
| Overhead and other expenses | 1,308 | 1,366 | (58) | (4)% |
| Depreciation | 394 | 458 | (64) | (14)% |
| Equity-based compensation | 392 | 553 | (161) | (29)% |
| Consulting | 23 | 646 | (623) | (96)% |
| Development reimbursement | (505) | | (505) | 100% |
| Total | \$ 6,445 | \$ 8,663 | \$ (2,218) | (26)% |

The decrease in research and development expenses for the three and six months ended June 30, 2009, compared to the same periods in 2008, was due to reduced headcount resulting from the November 2008 workforce reduction, lower utilization of consultants and other cost control measures. Additionally, during the 2009 first quarter, we entered into a co-development and collaboration agreement with Toshiba, in which the two companies will enter into a mutual license of intellectual property and will jointly invest to develop and deliver innovative technology advancements for Toshiba's medical equipment and our advanced visualization software solutions. During the three and six months ended June 30, 2009, we recognized a credit of \$262,000 and \$505,000, respectively, to our research and development expenses for reimbursement from Toshiba for development costs we incurred under the co-development agreement. We had 95 and 120 research and development personnel as of June 30, 2009 and 2008, respectively.

We will continue to devote resources to develop applications and solutions to improve the cost, quality and accessibility of health care.

Table of Contents**General and administrative**

General and administrative expenses are as follows (dollars in thousands):

| | For the Three Months Ended June 30, | | | |
|-------------------------------------|-------------------------------------|----------|----------|-------|
| | 2009 | 2008 | Change | |
| Salaries, benefits and bonuses | \$ 1,233 | \$ 1,367 | \$ (134) | (10)% |
| Overhead and other expenses | 855 | 835 | 20 | 2% |
| Accounting, auditing and legal fees | 189 | 237 | (48) | (20)% |
| Equity-based compensation | 363 | 570 | (207) | (36)% |
| Consulting | 73 | 321 | (248) | (77)% |
| Total | \$ 2,713 | \$ 3,330 | \$ (617) | (19)% |

| | For the Six Months Ended June 30, | | | |
|-------------------------------------|-----------------------------------|----------|------------|-------|
| | 2009 | 2008 | Change | |
| Salaries, benefits and bonuses | \$ 2,562 | \$ 2,751 | \$ (189) | (7)% |
| Overhead and other expenses | 1,528 | 1,661 | (133) | (8)% |
| Accounting, auditing and legal fees | 655 | 772 | (117) | (15)% |
| Equity-based compensation | 738 | 1,093 | (355) | (32)% |
| Consulting | 199 | 704 | (505) | (72)% |
| Total | \$ 5,682 | \$ 6,981 | \$ (1,299) | (19)% |

The decrease in general and administrative expenses during the three and six months ended June 30, 2009, compared to the same periods in 2008, was due in part to a lower utilization of consultants and reduced headcount resulting from the November 2008 workforce reduction. Equity-based compensation decreased for the three and six months ended June 30, 2009, compared to the same periods in 2008, as previously issued equity awards became fully vested and as headcount decreased. We had 49 and 52 general and administrative personnel as of June 30, 2009 and 2008, respectively.

We will continue to manage general and administrative expenses relative to changes in revenue.

Asset impairment

In 2007, we began the implementation of an enterprise resource planning (ERP) system. The ERP system was intended to replace numerous disconnected business management software applications and link the data contained within these disconnected systems to enable better management of our business and derive more useful data for various business functions, such as sales, marketing, finance and customer support.

Phase 1 of the implementation, which related to the replacement of our general ledger, was completed in 2007. The related capitalized costs are being depreciated over seven years and, as of June 30, 2009, the net book value of Phase 1 was \$693,000. Phase 2 of the implementation, which consisted of replacing our various customer relationship management and order processing systems, has not been implemented to date and was put on hold in 2008 in conjunction with our cost-control efforts, and we have not capitalized any costs relating to Phase 2 since that time. In

conjunction with continuing cost-control measures, we determined that we would not implement Phase 2 at this time. As a result, we recognized an asset impairment charge of \$3.1 million related to the Phase 2 implementation.

Interest income

We generated \$330,000 of interest income in the second quarter of 2009, compared to \$1.2 million in the second quarter of 2008, and generated \$760,000 of interest income for the first six months of 2009, compared to \$2.8 million for the first six months of 2008. The decrease for the three and six months ended June 30, 2009, compared to the same periods in 2008, was primarily due to a decline in interest rates and a decrease in cash, cash equivalents and marketable securities due primarily repurchases of our common stock under our share repurchase programs.

Table of Contents**Income taxes**

Companies are required to assess whether a valuation allowance should be recorded against their deferred tax assets based on the consideration of all available evidence, using a more likely than not realization standard. The four sources of taxable income that must be considered in determining whether deferred tax assets will be realized are: 1) future reversals of existing taxable temporary differences; 2) future taxable income exclusive of reversing temporary differences and carryforwards; 3) taxable income in prior carryback years if carryback is permitted under the tax law; and 4) tax planning strategies.

We have evaluated our deferred tax assets each reporting period, including making an assessment of cumulative pretax results in recent years and projections of cumulative pretax results in future periods. As a general guideline, we considered the cumulative pretax results from the most recent three years. A significant negative factor in our assessment at June 30, 2009 was that we will transition to a three-year historical cumulative pretax loss during 2009, as highly profitable quarters in 2006 are removed from the cumulative three-year pretax results. In addition, uncertain near-term market and economic conditions reduced our ability to rely on projections of future taxable income in assessing the realization of our deferred tax assets. As a result, during the three months ended June 30, 2009, we recorded a non-cash charge of \$15.0 million to the provision for income taxes to establish a full valuation allowance against our deferred tax assets, compared to a benefit of \$1.0 million for the three months ended June 30, 2008. If pretax results improve in future periods, we may be able to utilize the deferred tax assets to reduce tax payments.

Liquidity and capital resources

The following table sets forth certain relevant measures of our liquidity and capital resources (in thousands):

| | June 30, 2009 | December 31, 2008 |
|--|------------------|----------------------|
| Cash and cash equivalents | \$ 110,106 | \$ 109,706 |
| Marketable securities - current | 14,117 | 37,287 |
| Marketable securities - noncurrent | 16,879 | |
| Cash, cash equivalents and marketable securities | \$ 141,102 | \$ 146,993 |
| Working capital | \$ 113,864 | \$ 135,417 |
| Debt | \$ | \$ |

The decrease in our net cash position as of June 30, 2009, compared to December 31, 2008, is primarily due to \$5.8 million of share repurchases in the first six months of 2009 under our share repurchase programs. During the 2009 first quarter, we completed a \$40.0 million share repurchase program that commenced in 2008 and began a new share repurchase program, which authorizes up to an additional 1.0 million shares to be repurchased on the open market, pursuant to the parameters and conditions of a Rule 10b5-1 plan. As of June 30, 2009, 618,000 shares remained to be purchased under the program.

We believe our existing cash and investments will satisfy our foreseeable working capital requirements for at least the next 12 months. Additionally, we believe our liquidity and strong balance sheet enable us to execute our repurchases of common stock while still investing in our enterprise solution and marketing strategy and remaining well positioned to pursue strategic acquisitions if and when they emerge.

Table of Contents*Summary of Cash Flows*

A summary of cash flows is as follows (in thousands):

| | For the Six Months Ended | |
|---|---------------------------------|-------------|
| | June 30, | |
| | 2009 | 2008 |
| Cash provided by (used in): | | |
| Operating activities | \$ 931 | \$ 4,624 |
| Investing activities | 4,306 | (32,721) |
| Financing activities | (4,837) | (12,153) |
| Net change in cash and cash equivalents | \$ 400 | \$ (40,250) |

Operating activities

Net cash provided by operating activities decreased \$3.7 million in the first six months of 2009, compared to the same period in 2008, due to a \$17.7 million increase in net loss, an \$18.9 million increase in non-cash operating items and a \$4.9 million decrease due to the timing of other receipts and payments in the ordinary course of business. The increase in non-cash operating items primarily resulted from a \$14.6 million decrease in deferred tax assets due primarily to the \$15.0 million valuation allowance recorded in the second quarter of 2009 and a \$3.1 million asset impairment in the second quarter of 2009.

Investing activities

Cash provided by investing activities was \$4.3 million for the first six months of 2009, compared to cash used by investing activities of \$32.7 million for the same period in 2008.

We used \$16.8 million and \$68.4 million to purchase investments in marketable securities during the first six months of 2009 and 2008, respectively. We realized \$22.7 million and \$38.5 million of proceeds from maturities and sales of marketable securities during the first six months of 2009 and 2008, respectively. The marketable securities consist of U.S. government obligations, U.S. government agency obligations and corporate commercial obligations.

We used \$1.6 million and \$2.8 million for purchases of property and equipment in the first six months of 2009 and 2008, respectively. Purchases during the six months ended June 30, 2009 were principally to upgrade computer equipment. Purchases during the six months ended June 30, 2008 were principally to upgrade computer equipment and implement our enterprise resource planning 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.

Financing activities

Cash used by financing activities totaled \$4.8 million and \$12.2 million for the first six months of 2009 and 2008, respectively. The primary use of cash was for the repurchase of \$5.8 million and \$13.3 million of our common stock under our share repurchase programs in the first six months of 2009 and 2008, respectively.

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

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Off-balance-sheet arrangements

We did not have any off-balance sheet arrangements as of June 30, 2009 or December 31, 2008.

Other purchase commitments

We had no significant outstanding purchase orders as of June 30, 2009. We have entered into a number of technology licensing agreements that provide for the payment of royalties when we sell our products. We are not obligated for any minimum payments under such agreements.

Foreign currency transactions

Our export sales are primarily negotiated, invoiced and paid in U.S. dollars, with a portion of sales transactions denominated in foreign currencies. As we expand our direct business internationally, we expect to enter into a higher percentage of sales transactions in foreign currencies and could be subject to greater gains or losses based on exchange rate fluctuations.

Inflation

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

Recent accounting pronouncements

Information regarding new accounting pronouncements is included in Note 14 to the Consolidated Financial Statements included in this Quarterly Report on Form 10-Q.

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

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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. Except as required by law, 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 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

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entitled Item 1A.Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2008 (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, 2008, 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 at a reasonable assurance level.

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

There were no changes in internal control over financial reporting during the quarter ended June 30, 2009 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents**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, 2008. 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

c) The following table presents information with respect to purchases of Vital Images, Inc. common stock made during the quarter ended June 30, 2009 by us or our affiliated purchaser, as defined in Rule 10b-18(a)(3) under the Exchange Act.

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs |
|------------------|---|-------------------------------------|---|---|
| April 1-30, 2009 | 54,658 | \$ 10.67 | 54,658 | 799,907 |
| May 1-31, 2009 | 156,707 | \$ 10.49 | 156,707 | 643,200 |
| June 1-30, 2009 | 25,107 | \$ 10.91 | 25,107 | 618,093 |
| | 236,472 | \$ 10.58 | 236,472 | 618,093 |

On May 8, 2008, we announced a share repurchase program of up to \$25.0 million of our common stock. On August 7, 2008, we announced additional repurchases of up to \$15.0 million of our common stock, allowing for total repurchases of up to \$40.0 million of our common stock under the share repurchase program. We completed this share repurchase program on February 6, 2009 through only open market transactions. On March 3, 2009, we announced a new share repurchase program, under which we may repurchase up to 1.0 million shares of our common stock. The new share repurchase program expires on February 28, 2010.

Item 3. Defaults upon Senior Securities

None.

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

- a) We held an Annual Meeting of Shareholders on May 14, 2009.

- b) At the Annual Meeting of Shareholders, James B. Hickey, Jr., Michael H. Carrel, Gregory J. Peet, Richard W. Perkins, Douglas M. Pihl, Michael W. Vannier, M.D. and Sven A. Wehrwein, constituting all of the members of our Board, were elected to the Board.

- c) At the Annual Meeting of Shareholders held on May 14, 2009, the following proposals were adopted by the votes indicated:
 - 1. Elect a Board of Directors to hold offices until the next Annual Meeting of Shareholders and until their successors are elected and qualified.

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| | Number of Shares Voted | |
|--------------------------|------------------------|-----------|
| | For | Withheld |
| James B. Hickey, Jr. | 12,752,936 | 802,390 |
| Michael H. Carrel | 13,183,439 | 371,887 |
| Gregory J. Peet | 11,578,736 | 1,976,590 |
| Richard W. Perkins | 12,992,383 | 562,943 |
| Douglas M. Pihl | 9,413,503 | 4,141,823 |
| Michael W. Vannier, M.D. | 13,223,087 | 332,239 |
| Sven A. Wehrwein | 11,622,264 | 1,933,062 |

2. Ratify the appointment of PricewaterhouseCoopers LLP as our independent registered public accounting firm for the year ending December 31, 2009.

| For | Number of Shares Voted | | Broker Non-votes |
|------------|------------------------|------------|---------------------|
| | Against | Abstaining | |
| 13,338,784 | 209,275 | 7,266 | |

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).

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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.

VITAL IMAGES, INC.

Date: August 10, 2009

/s/ Peter J. Goepfrich
Peter J. Goepfrich
Chief Financial Officer
(Principal Financial Officer and Principal Accounting Officer)