

MERGE TECHNOLOGIES INC
Form 10-Q
August 30, 2006

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2006

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

For the transition period from _____ to _____

Commission file number 0-29486

MERGE TECHNOLOGIES INCORPORATED

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

Wisconsin

(State or other jurisdiction of
incorporation or organization)

39-1600938

(IRS Employer Identification No.)

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

(Address of principal executive offices)

(414) 977-4000

(Registrant's telephone number, including area code)

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

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As of August 22, 2006, the Registrant had 29,069,624 shares of Common Stock outstanding.

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MERGE TECHNOLOGIES INCORPORATED

EXPLANATORY NOTE RESTATEMENT OF FINANCIAL INFORMATION

This Quarterly Report on Form 10-Q for the three months ended March 31, 2006, includes a restated consolidated statement of operations, consolidated statement of shareholders' equity, consolidated statement of cash flows and consolidated statement of comprehensive income for the three months ended March 31, 2005. The Company will not file an amended Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2005. See Item 1, Financial Statements, and Item 4 Controls and Procedures, in Part I of this Quarterly Report on Form 10-Q, including Note 1 to the notes to consolidated financial statements, for more information concerning these restatements. This Quarterly Report on Form 10-Q should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2005, which is being filed contemporaneously with this Form 10-Q.

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

	March 31, 2006 (Unaudited)	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 65,128	\$ 64,278
Accounts receivable, net of allowance for doubtful accounts of \$1,705 and \$1,892 at March 31, 2006 and December 31, 2005, respectively	20,061	23,624
Inventory	2,838	2,440
Prepaid expenses	3,276	2,646
Deferred income taxes	11,213	11,213
Other current assets	2,947	3,208
Total current assets	105,463	107,409
Property and equipment:		
Computer equipment	4,300	4,025
Office equipment	1,739	1,759
Leasehold improvements	1,372	1,372
	7,411	7,156
Less accumulated depreciation	3,157	2,716
Net property and equipment	4,254	4,440
Purchased and developed software, net of accumulated amortization of \$7,898 and \$6,759 at March 31, 2006 and December 31, 2005, respectively	19,147	19,539
Acquired intangibles, net of accumulated amortization of \$2,257 and \$1,687 at March 31, 2006 and December 31, 2005, respectively	11,219	11,789
Goodwill	350,521	350,634
Other assets	7,312	7,862
Total assets	\$ 497,916	\$ 501,673
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	\$ 5,650	\$ 5,938
Accrued wages	5,198	5,870
Taxes payable	3,894	3,894
Other accrued liabilities	3,762	3,453
Deferred revenue	33,517	30,918
Total current liabilities	52,021	50,073
Deferred income taxes	1,839	3,491
Deferred revenue	3,396	3,784
Other	453	484
Total liabilities	57,709	57,832
Shareholders' equity:		
Preferred stock, \$0.01 par value: 3,999,997 shares authorized; zero shares issued and outstanding at March 31, 2006 and December 31, 2005		
Series A Preferred Stock, \$0.01 par value: 1,000,000 shares authorized; zero shares issued and outstanding at March 31, 2006 and December 31, 2005		
Special Voting Preferred stock, no par value: one share authorized; zero shares issued and outstanding at March 31, 2006 and December 31, 2005		
Series 2 Special Voting Preferred stock, no par value: one share authorized; zero shares issued and outstanding at March 31, 2006 and December 31, 2005		
Series 3 Special Voting Preferred stock, no par value: one share authorized; one share issued and outstanding at March 31, 2006 and December 31, 2005		
Common stock, \$0.01 par value: 100,000,000 shares authorized: 29,069,624 shares and 26,500,140 shares issued and outstanding at March 31, 2006 and December 31, 2005, respectively	291	265
Common stock subscribed; zero shares and 706 shares at March 31, 2006 and December 31, 2005, respectively		17
Additional paid-in capital	446,014	445,954
Deferred stock compensation		(1,245)

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Accumulated deficit	(8,090)	(3,190)
Accumulated other comprehensive income	1,992	2,040
Total shareholders' equity	440,207	443,841
Total liabilities and shareholders' equity	\$ 497,916	\$ 501,673

See accompanying notes to consolidated financial statements.

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

	Three Months Ended March 31, 2006	2005 (As restated)
Net sales:		
Software and other	\$ 9,545	\$ 4,648
Services and maintenance	6,651	2,289
Total net sales	16,196	6,937
Cost of sales:		
Software and other	1,372	570
Services and maintenance	3,686	1,634
Amortization	1,277	702
Total cost of sales	6,335	2,906
Gross profit	9,861	4,031
Operating costs and expenses:		
Sales and marketing	5,221	1,580
Product research and development	5,129	753
General and administrative	5,841	1,218
Restructuring and other expenses	22	
Depreciation and amortization	1,042	303
Total operating costs and expenses	17,255	3,854
Operating income (loss)	(7,394)	177
Other income (expense):		
Interest expense	(4)	
Interest income	660	120
Other, net	20	(43)
Total other income	676	77
Income (loss) before income taxes	(6,718)	254
Income tax expense (benefit)	(1,818)	89
Net income (loss)	\$ (4,900)	\$ 165
Net income (loss) per share basic	\$ (0.15)	\$ 0.01
Weighted average number of common shares outstanding basic	33,634,778	13,208,370
Net income (loss) per share diluted	\$ (0.15)	\$ 0.01
Weighted average number of common shares outstanding diluted	33,634,778	13,992,241

See accompanying notes to consolidated financial statements.

MERGE TECHNOLOGIES INCORPORATED AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)
(in thousands, except for share data)

	Three Months Ended March 31,	
	2006	2005 (As restated)
Cash flows from operating activities:		
Net income (loss)	\$ (4,900)	\$ 165
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	2,318	1,005
Stock-based compensation	1,289	
Provision for doubtful accounts receivable, net of recoveries	(177)	(30)
Deferred income taxes	(1,652)	(128)
Change in assets and liabilities, excluding effects from acquisitions:		
Accounts receivable	3,740	(932)
Inventory	(398)	8
Prepaid expenses	(692)	(636)
Accounts payable	(288)	639
Accrued wages	(672)	(587)
Other accrued liabilities	451	(144)
Deferred revenue	2,212	3,473
Other assets	938	(1,077)
Other	(173)	710
Net cash provided by operating activities	1,996	2,466
Cash flows from investing activities:		
Cash paid for acquisitions, net of cash acquired		(6,808)
Purchases of property, equipment, and leasehold improvements	(254)	(428)
Purchased technology	(367)	
Capitalized software development	(549)	(880)
Net cash used in investing activities	(1,170)	(8,116)
Cash flows from financing activities:		
Proceeds from exercise of stock options	25	144
Proceeds from employee stock purchase plan		11
Net cash provided by financing activities	25	155
Effect of exchange rate changes on cash		(3)
Net increase (decrease) in cash	851	(5,498)
Cash and cash equivalents, beginning of period	64,278	28,067
Cash and cash equivalents, end of period	\$ 65,128	\$ 22,569
Supplemental Disclosures of Cash Flow Information:		
Cash paid for income taxes	\$ 69	\$ 214

See accompanying notes to consolidated financial statements.

MERGE TECHNOLOGIES INCORPORATED AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY
(unaudited)
(in thousands, except for share data)

	Preferred Stock		Common Stock				Additional paid-in capital	Deferred stock compensation	Accumulated deficit	Accumulated other comprehensive income	Total shareholders equity
	Shares issued	Issued amount	Shares subscribed	Subscribed amount	Shares issued	Issued amount					
Balance at December 31, 2005	1	\$	706	\$ 17	26,500,140	\$ 265	\$ 445,954	\$ (1,245)	\$ (3,190)	\$ 2,040	\$ 443,841
Cedara exchange of share rights into Common Stock					2,561,085	26	(26)				
Stock purchased under ESPP			(706)	(17)	706	17					
Exercise of employee stock options					7,693	25					25
Reclassification of deferred compensation upon adoption of SFAS No. 123R							(1,245)	1,245			
Stock compensation expense						1,289					1,289
Net loss									(4,900)		(4,900)
Unrealized loss on marketable securities										(48)	(48)
Balance at March 31, 2006	1	\$		\$	29,069,624	\$ 291	\$ 446,014	\$	\$ (8,090)	\$ 1,992	\$ 440,207

See accompanying notes to consolidated financial statements.

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

	Three Months Ended	
	March 31,	2005
	2006	(As restated)
Net income (loss)	\$ (4,900)	\$ 165
Accumulated other comprehensive income:		
Cumulative translation adjustment(1)		18
Unrealized loss on marketable securities(2)	(29)	
Comprehensive net income (loss)	\$ (4,929)	\$ 183

(1) Net of income tax of \$(9) for the three months ended March 31, 2005.

(2) Net of income tax of \$19 for the three months ended March 31, 2006.

See accompanying notes to consolidated financial statements.

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

(1) Basis of Presentation and Significant Accounting Policies

The accompanying unaudited consolidated financial statements have been prepared pursuant to the rules and regulations of Securities and Exchange Commission (SEC) for reporting on Form 10-Q. Accordingly, certain information and footnotes required by United States of America generally accepted accounting principles (GAAP) for complete financial statements are not included herein. The interim statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Annual Report on Form 10-K for the year ended December 31, 2005 of Merge Technologies Incorporated, a Wisconsin corporation, and its subsidiaries and affiliates (which we sometimes refer to collectively as Merge, we, us or our). Since June 2005, we have been doing business under the trade name Merge Healthcare.

Our accompanying unaudited consolidated financial statements reflect all adjustments of a normal recurring nature, which are, in the opinion of management, necessary to present a fair statement of our financial position and results of operations. The results of operations for any quarter are not necessarily indicative of the results to be expected for any future period.

Restatement of Consolidated Financial Statements

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

On June 29, 2006, soon after Sidley Austin LLP completed its investigation, Sidley Austin LLP reported its findings to the Audit Committee, and the Audit Committee determined that, because of improper accounting and financial reporting practices with respect to reporting periods in the fiscal years 2002 through 2005, the previously issued financial statements for each of the reporting periods in 2002 through 2005 should no longer be relied upon. Furthermore, the audit reports of KPMG LLP with respect to those previously issued financial statements (including the report of KPMG with respect to management's assessment of, and the effectiveness of, our internal control over financial reporting) should no longer be relied upon. On June 30, 2006, the Audit Committee presented its recommendations to all of our non-employee directors. On July 2, 2006, our Board of Directors held a meeting at which it accepted the resignations of each of William C. Mortimore, our former interim Chief Executive Officer, Scott T. Veech, our former Chief Financial Officer, Treasurer and Secretary, and David M. Noshay, our former

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

Senior Vice President, Strategic Business Development, from all positions with us and our subsidiaries, including as officers, employees and directors.

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

Revenue Recognition

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

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

In the aggregate, these revenue recognition errors resulted in the deferral of approximately \$3,800 of net sales in the three months ended March 31, 2005.

Income Tax Expense

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

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

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

Other Adjustments

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

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

MERGE TECHNOLOGIES INCORPORATED AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(in thousands)

	March 31, 2005 (As reported)	Adjustments	March 31, 2005 (As restated)
ASSETS			
Current assets:			
Cash and cash equivalents	\$ 22,569		\$ 22,569
Accounts receivable, net(a)	12,552	\$ (995)	11,557
Inventory	1,094		1,094
Prepaid expenses(b)	1,069	281	1,350
Deferred income taxes(c)	2,841	5,273	8,114
Other current assets(d)	1,951	3,231	5,182
Total current assets	42,076	7,790	49,866
Net property and equipment	1,758		1,758
Purchased and developed software, net	10,685		10,685
Acquired intangibles, net	1,163		1,163
Goodwill	25,995		25,995
Other assets	775	(2)	773
Total assets	\$ 82,452	\$ 7,788	\$ 90,240
LIABILITIES AND SHAREHOLDERS EQUITY			
Current liabilities:			
Accounts payable(b)	\$ 2,888	\$ (11)	\$ 2,877
Accrued wages	896		896
Other accrued liabilities(b)	1,727	(204)	1,523
Deferred revenue(a)	9,025	19,073	28,098
Total current liabilities	14,536	18,858	33,394
Deferred income taxes(c)	2,060	(1,195)	865
Total liabilities	16,596	17,663	34,259
Total shareholders equity	65,856	(9,875)	55,981
Total liabilities and shareholders equity	\$ 82,452	\$ 7,788	\$ 90,240

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

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

	Three Months Ended March 31, 2005 (As reported)	Adjustments	Three Months Ended March 31, 2005 (As restated)
Net sales:			
Software and other(a)	\$ 7,109	\$ (2,461)	\$ 4,648
Services and maintenance(a)	3,392	(1,103)	2,289
Total net sales	10,501	(3,564)	6,937
Cost of sales:			
Software and other(d)	989	(419)	570
Services and maintenance	1,634		1,634
Amortization(e)	806	(104)	702
Total cost of sales	3,429	(523)	2,906
Gross margin	7,072	(3,041)	4,031
Operating costs and expenses:			
Sales and marketing(b)	1,655	(75)	1,580
Product research and development	753		753
General and administrative(a)	1,318	(100)	1,218
Depreciation and amortization(e)	199	104	303
Total operating costs and expenses	3,925	(71)	3,854
Operating income	3,147	(2,970)	177
Other income	77		77
Income before income taxes	3,224	(2,970)	254
Income tax expense(c)	1,128	(1,039)	89
Net income	\$ 2,096	\$ (1,931)	\$ 165
Net income per share basic	\$ 0.16	(0.15)	\$ 0.01
Weighted average number of shares of Common Stock			
outstanding basic	13,208,370		13,208,370
Net income per share diluted	\$ 0.15	(0.14)	\$ 0.01
Weighted average number of shares of Common Stock			
outstanding diluted	13,992,241		13,992,241

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

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

	Three Months Ended March 31, 2005 (As reported)	Adjustments	Three Months Ended March 31, 2005 (As restated)
Cash flows from operating activities:			
Net income	\$ 2,096	\$	