MERGE TECHNOLOGIES INC
Form 10-Q
August 09, 2005

# UNITED STATES
# SECURITIES AND EXCHANGE COMMISSION

**Washington, D. C. 20549**

# FORM 10-Q

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

**For the quarterly period ended June 30, 2005**

| | |
|---|---|
| **o** | **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** | **39-1600938** |
| (State or other jurisdiction of incorporation or organization) | (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 ý No o

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).
Yes ý No o

As of August 5, 2005, the Registrant had 19,659,019 shares of Common Stock outstanding.

**INDEX**

**PART I**

**Item 1. Consolidated Financial Statements**

**MERGE TECHNOLOGIES INCORPORATED AND SUBSIDIARIES**

**CONSOLIDATED BALANCE SHEETS**

**(in thousands, except for share data)**

| | | June 30, 2005 (Unaudited) | | December 31, 2004 |
|---|---|---|---|---|
| ASSETS | | | | |
| Current assets: | | | | |
| Cash and cash equivalents | $ | 39,830 | $ | 28,067 |
| Accounts receivable, net of allowance for doubtful accounts of $1,134 and $497 at June 30, 2005 and December 31, 2004, respectively | | 24,944 | | 11,100 |
| Inventory | | 1,814 | | 1,082 |
| Prepaid expenses | | 2,507 | | 495 |
| Deferred income taxes | | 2,936 | | 3,076 |
| Other current assets | | 1,733 | | 1,417 |
| Total current assets | | 73,764 | | 45,237 |
| Property and equipment: | | | | |
| Computer equipment | | 3,073 | | 5,275 |
| Office equipment | | 1,217 | | 755 |
| Leasehold improvements | | 1,338 | | 351 |
| | | 5,628 | | 6,381 |
| Less accumulated depreciation | | 1,746 | | 4,884 |
| Net property and equipment | | 3,882 | | 1,497 |
| Purchased and developed software, net of accumulated amortization of $5,550 and $9,804 at June 30, 2005 and December 31, 2004, respectively | | 22,905 | | 9,751 |
| Acquired intangibles, net of accumulated amortization of $543 and $760 at June 30, 2005 and December 31, 2004, respectively | | 12,934 | | 1,183 |
| Goodwill | | 353,832 | | 21,167 |
| Other assets | | 1,947 | | 108 |
| Total assets | $ | 469,264 | $ | 78,943 |
| LIABILITIES AND SHAREHOLDERS EQUITY | | | | |
| Current liabilities: | | | | |
| Accounts payable | $ | 7,301 | $ | 2,020 |
| Accrued wages | | 5,988 | | 1,414 |
| Other accrued liabilities | | 5,635 | | 1,202 |
| Deferred revenue | | 12,852 | | 8,678 |
| Total current liabilities | | 31,776 | | 13,314 |
| Deferred income taxes and other | | 2,251 | | 2,062 |
| Total liabilities | | 34,027 | | 15,376 |
| | | | | |
| Shareholders equity: | | | | |
| Preferred stock, $0.01 par value: 3,999,997 shares authorized; zero shares issued and outstanding at June 30, 2005 and December 31, 2004, respectively | | | | |

| | | | | |
|---|---|---|---|---|
| Series A Preferred Stock, $0.01 par value: 1,000,000 shares authorized; zero shares issued and outstanding at June 30, 2005 and December 31, 2004, respectively | | | | |
| Special Voting Preferred stock, no par value: one share authorized; zero shares issued and outstanding at June 30, 2005 and December 31, 2004, respectively | | | | |
| Series 2 Special Voting Preferred stock, no par value: one share authorized; zero shares issued and outstanding at June 30, 2005 and December 31, 2004, respectively | | | | |
| Series 3 Special Voting Preferred stock, no par value: one share authorized; one share issued and outstanding at June 30, 2005 and zero shares issued and outstanding at December 31, 2004 | | | | |
| Common Stock, $0.01 par value: 100,000,000 shares authorized; 18,925,642 shares and 13,186,185 shares issued and outstanding at June 30, 2005 and December 31, 2004, respectively | | 189 | | 132 |
| Common Stock subscribed: 1,034 and 817 shares at June 30, 2005 and December 31, 2004, respectively | | 18 | | 14 |
| Additional paid-in capital | | 437,388 | | 55,418 |
| Deferred stock compensation | | (2,003) | | |
| Retained earnings (accumulated deficit) | | (2,370) | | 7,411 |
| Accumulated other comprehensive income | | 2,015 | | 592 |
| Total shareholders equity | | 435,237 | | 63,567 |
| Total liabilities and shareholders equity | $ | 469,264 | $ | 78,943 |

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**MERGE TECHNOLOGIES INCORPORATED AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF OPERATIONS**

**(Unaudited)**

**(in thousands, except for share data)**

| | Three Months Ended June 30, 2005 | Three Months Ended June 30, 2004 | Six Months Ended June 30, 2005 | Six Months Ended June 30, 2004 |
|---|---|---|---|---|
| Net sales: | | | | |
| Software and other | $ 13,755 | $ 6,113 | $ 20,864 | $ 12,268 |
| Services and maintenance | 5,018 | 2,794 | 8,410 | 5,276 |
| Total net sales | 18,773 | 8,907 | 29,274 | 17,544 |
| Cost of sales: | | | | |
| Software and other | 2,066 | 962 | 3,055 | 2,077 |
| Services and maintenance | 2,478 | 1,568 | 4,113 | 3,034 |
| Amortization | 1,881 | 642 | 2,686 | 1,280 |
| Total cost of sales | 6,425 | 3,172 | 9,854 | 6,391 |
| Gross profit | 12,348 | 5,735 | 19,420 | 11,153 |
| Operating costs and expenses: | | | | |
| Sales and marketing | 2,880 | 1,711 | 4,535 | 3,405 |
| Product research and development | 1,648 | 423 | 2,401 | 905 |
| General and administrative | 4,122 | 1,024 | 5,440 | 1,936 |
| Acquired in-process research and development | 12,989 | | 12,989 | |
| Restructuring and other expenses | 589 | | 589 | |
| Depreciation and amortization | 1,093 | 196 | 1,292 | 385 |
| Total operating costs and expenses | 23,321 | 3,354 | 27,246 | 6,631 |
| Operating income (loss) | (10,973) | 2,381 | (7,826) | 4,522 |
| Other income (expense): | | | | |
| Interest expense | | (5) | | (10) |
| Interest income | 170 | 49 | 290 | 103 |
| Other, net | (83) | 64 | (126) | 67 |
| Total other income | 87 | 108 | 164 | 160 |
| Income (loss) before income taxes | (10,886) | 2,489 | (7,662) | 4,682 |
| Income tax expense | 991 | 992 | 2,119 | 1,831 |
| Net income (loss) | $ (11,877) | $ 1,497 | $ (9,781) | $ 2,851 |
| | | | | |
| Net income (loss) per share basic | $ (0.62) | $ 0.12 | $ (0.60) | $ 0.22 |
| Weighted average number of common shares outstanding basic | 19,254,640 | 12,968,889 | 16,248,205 | 12,927,877 |
| | | | | |
| Net income (loss) per share diluted | $ (0.62) | $ 0.11 | $ (0.60) | $ 0.21 |
| Weighted average number of common shares outstanding diluted | 19,254,640 | 13,782,440 | 16,248,205 | 13,773,980 |

**MERGE TECHNOLOGIES INCORPORATED AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

**(Unaudited)**

**(in thousands)**

| | Six Months Ended June 30 2005 | | Six Months Ended June 30 2004 | |
|---|---|---|---|---|
| Cash flows from operating activities: | | | | |
| Net income (loss) | $ | (9,781) | $ | 2,851 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | | |
| Depreciation and amortization | | 3,978 | | 1,665 |
| Amortization of discount on note assumed in merger | | | | 8 |
| Provision for doubtful accounts receivable, net of recoveries | | 470 | | 11 |
| In-process research and development | | 12,989 | | |
| Stock compensation expense | | 166 | | |
| Deferred income taxes | | 693 | | 885 |
| Change in assets and liabilities, excluding effects from acquisitions: | | | | |
| Accounts receivable | | (5,541) | | (413) |
| Inventory | | 187 | | (65) |
| Prepaid expenses | | (66) | | (185) |
| Accounts payable | | (2,296) | | (186) |
| Accrued wages | | 882 | | (92) |
| Other accrued liabilities | | (805) | | 284 |
| Deferred revenue | | 1,013 | | 720 |
| Other | | 1,340 | | (9) |
| Net cash provided by operating activities | | 3,229 | | 5,474 |
| Cash flows from investing activities: | | | | |
| Acquisitions, net of cash acquired | | 10,782 | | |
| Purchases of property and equipment | | (1,388) | | (253) |
| Capitalized software development | | (1,781) | | (1,873) |
| Net cash provided by (used in) investing activities | | 7,613 | | (2,126) |
| Cash flows from financing activities: | | | | |
| Proceeds from exercise of stock options | | 848 | | 454 |
| Proceeds from employee stock purchase plan | | 29 | | 37 |
| Net cash provided by financing activities | | 877 | | 491 |
| Effect of exchange rate changes on cash | | 44 | | (27) |
| Net increase in cash | | 11,763 | | 3,812 |
| Cash and cash equivalents, beginning of period | | 28,067 | | 16,871 |
| Cash and cash equivalents, end of period | $ | 39,830 | $ | 20,683 |
| **Supplemental Disclosures of Cash Flow Information:** | | | | |
| Cash paid for income taxes | $ | 911 | $ | 813 |
| **Non Cash Investing and Financing Activities:** | | | | |
| Redemption value related to exchangeable Common Stock | | | $ | 1 |
| Value of Common Stock and options issued for acquisitions | $ | 381,689 | | |

**MERGE TECHNOLOGIES INCORPORATED AND SUBSIDIARIES**

**CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY**

**(in thousands, except share data)**

| | Preferred Stock | | Common Stock | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | **Shares issued** | **Issued amount** | **Shares subscribed** | **Subscribed amount** | **Shares issued** | **Issued amount** | **Additional paid-in capital** | **Deferred stock compensation** | **Retained earnings (accumulated deficit)** | **Other comprehensive income** | **Total shareholders equity** |
| Balance at December 31, 2004 | | $ | 817 | $ 14 | 13,186,185 | $ 132 | $ 55,418 | $ | $ 7,411 | $ 592 | $ 63,567 |
| Stock issued and options granted for acquisitions, net | 1 | | | | 5,581,517 | 56 | 380,774 | | | | 380,830 |
| Stock purchased under ESPP | | | 217 | 4 | 1,427 | | 25 | | | | 29 |
| Exercise of stock options | | | | | 156,513 | 1 | 896 | | | | 897 |
| Deferred stock compensation | | | | | | | | (2,132) | | | (2,132) |
| Stock compensation expense | | | | | | | 37 | 129 | | | 166 |
| Tax benefit on exercise of stock options | | | | | | | 238 | | | | 238 |
| Net income (loss) | | | | | | | | | (9,781) | | (9,781) |
| Other comprehensive income | | | | | | | | | | 1,423 | 1,423 |
| Balance at June 30, 2005 | 1 | $ | 1,034 | $ 18 | 18,925,642 | $ 189 | $ 437,388 | $ (2,003) | $ (2,370) | $ 2,015 | $ 435,237 |

**MERGE TECHNOLOGIES INCORPORATED AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

**(Unaudited)**

**(in thousands)**

| | Three Months Ended June 30, 2005 | Three Months Ended June 30, 2004 | Six Months Ended June 30, 2005 | Six Months Ended June 30, 2004 |
|---|---|---|---|---|
| Net income (loss) | $ (11,877) | $ 1,497 | $ (9,781) | $ 2,851 |
| Accumulated other comprehensive income | | | | |
| Cumulative translation adjustment, net of income tax expense of 35% in 2005 and 39% in 2004, respectively | 921 | 20 | 951 | (9) |
| Unrealized investment loss, net of income tax expense of 35% in 2005 | (26) | | (26) | |
| Comprehensive net income (loss) | $ (10,982) | $ 1,517 | $ (8,856) | $ 2,842 |

**Merge Technologies Incorporated and Subsidiaries**

**Notes to Consolidated Financial Statements**

**(Unaudited and in thousands, except for 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 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 latest Annual Report on Form 10 K of Merge Technologies Incorporated, a Wisconsin corporation, and its subsidiaries and affiliates (which we sometimes refer to collectively as Merge, we, us or our ). As of June 2005 we are 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.

*(a) Reporting Periods Presented*

The accompanying unaudited consolidated financial statements do not include the results of Cedara Software Corp. ( Cedara ) prior to the business combination between Merge and Cedara on June 1, 2005 or the results of AccuImage Diagnostics Corp. ( AccuImage ) prior to our acquisition of AccuImage on January 28, 2005.

*(b) Use of Estimates*

Our consolidated financial statements are prepared in accordance with GAAP. These accounting principles require us to make certain estimates, judgments and assumptions. We believe that the estimates, judgments and assumptions are reasonable, based on information available at the time they are made. As discussed in Note 5, due to the timing of the closing of the business combination with Cedara, we have preliminarily allocated the purchase price to Cedara s assets and liabilities and expect the allocation to change in future reporting periods. To the extent there are material differences between these estimates and actual results, our consolidated financial statements will be affected.

*(c) Reclassifications*

Certain reclassifications have been made to the 2004 financial statements to conform to the 2005 presentation.

*(d)* *Functional Currency*

On June 1, 2005, we changed the functional currency of our subsidiary, eFilm Medical Inc. ( eFilm ), from the Canadian dollar to the United States of America dollar ( U. S. Dollar ). This change was due to significant changes in the economic facts and circumstances surrounding the operational environment of this subsidiary. As a result of this change, certain long lived assets, which were previously translated from Canadian dollars to U. S. Dollars at the historical exchange rate on the date the asset was acquired, were revalued based upon the exchange rate as of June 1, 2005 leading to a currency translation adjustment, reflected in other comprehensive income, and increase in the value of applicable assets of approximately $1,520.

*(e)* *Revenue Recognition*

Revenues are derived primarily from the sublicensing and licensing of software, installation and engineering services, training, consulting, and software maintenance and support. Inherent in the revenue recognition process are significant management estimates and judgments, which influence the timing and amount of revenue recognized.

For software arrangements, we recognize revenue according to the American Institute of Certified Public Accountants ( AICPA ), Statement of Position No. 97 2, *Software Revenue Recognition,* and related amendments

( SOP No. 97 2 ). SOP No. 97 2, as amended, generally requires revenue earned on software arrangements involving multiple elements to be allocated to each element based on the relative fair values of those elements. Revenue from multiple element software arrangements is recognized using the residual method, pursuant to Statement of Position No. 98 9, *Modification of SOP No. 97 2, Software Revenue Recognition, With Respect to Certain Transactions* ( SOP No. 98 9 ). Under the residual method, revenue is recognized in a multiple element arrangement when vendor specific objective evidence of fair value exists for all of the undelivered elements in the arrangement, but does not exist for one or more of the delivered elements in the arrangement. For sales transactions where the software is incidental, and hardware transactions where no software is involved, we consider the provisions of Staff Accounting Bulletin 104, *Revenue Recognition*, ( SAB No. 104 ) and Financial Accounting Standards Board s ( FASB ) Emerging Issues Task Force Issue No. 00 21, *Revenue Arrangements with Multiple Deliverables* ( EITF No. 00 21 ).

We allocate revenue to each undelivered element in a multiple element arrangement based on its respective fair value, with the fair value determined by the price charged when that element is sold separately. Specifically, we determine the fair value of the maintenance portion of the arrangement based on the renewal price of the maintenance offered to customers, which is generally stated in the contract, and fair value of the installation and training based upon the price charged when these services are sold separately. If evidence of the fair value cannot be established for undelivered elements of a software sale, the entire amount of revenue under the arrangement is deferred until these elements have been delivered or vendor specific objective evidence of fair value can be established.

Revenue from sublicenses sold on an individual basis and software licenses is recognized upon shipment provided that evidence of an arrangement exists, delivery has occurred and risk of loss has passed to the customer, fees are fixed or determinable and collection of the related receivable is reasonably assured. We assess collectibility based on a number of factors, including past transaction history with the customer and the credit worthiness of the customer. We generally do not request collateral from customers.

Revenue from software usage sublicenses sold through annual contracts and software maintenance and support is deferred and recognized ratably over the contract period. Revenue from installation and engineering services, training, and consulting services is recognized as services are performed.

Revenue from sales of RIS and from RIS/PACS solutions, where professional services are considered essential to the functionality of the solution sold, is recognized on the percentage of completion method, as prescribed by AICPA Statement of Position 81 1, *Accounting for Performance on Construction Type and Certain Production Type Contracts*. Percentage of completion is determined by the input method based upon the amount of labor hours expended compared to the total estimated amount of labor hours to complete the project. Total estimated labor hours is based on management s best estimate of the total amount of time it will take to complete a project. These estimates require the use of judgment. A significant change in one or more of these estimates could affect the profitability of one or more of our contracts. We review our contract estimates periodically to assess revisions in contract values and estimated labor hours expended and reflect changes in estimates in the period that such estimates are revised under the cumulative catch up method.

Our Original Equipment Manufacturer ( OEM ) software products are fully functional upon delivery and do not require significant modification or alteration. Fees for services to OEM customers are billed separately from licenses of our software products. We provide engineering services to our OEM customers under time and material or fixed price contracts that are generally longer than one year in duration. Under engineering service contracts where the services are performed and costs incurred in proportion with contracted billing schedules, revenue is recognized when the customer may be billed. This method is expected to result in reasonably consistent profit margins over the contract term. For certain fixed price contracts, we use percentage of completion accounting.

For contracts accounted for under SAB No. 104, we generally invoice the customer 10% of the fair value of the products delivered upon completion of hardware installation and acceptance by the customer. As a result of this

specific performance obligation and acceptance criteria, we defer the related amount of product fair value and recognize it upon completion of installation and acceptance.

Our policy is to allow returns when we have preauthorized the return. Based on our historical experience of a limited number of returns and our expectation that returns, if any, will be insignificant, we have provided for an allowance for specific potential items only.

*(2) Goodwill and Other Intangibles*

Goodwill is our primary unamortizable intangible asset. In the six months ended June 30, 2005, we increased goodwill by $332,665 due to the business combination with Cedara and acquisition of AccuImage, as well as the change in functional currency of eFilm. The changes in the carrying amount of goodwill in the six months ended June 30, 2005, are as follows:

| | | |
|---|---|---|
| Balance as of January 1, 2005 | $ | 21,167 |
| Goodwill related to Cedara acquisition | | 326,527 |
| Goodwill related to AccuImage acquisition | | 4,805 |
| Change related to functional currency | | 1,333 |
| Balance as of June 30, 2005 | $ | 353,832 |

Our intangible assets, other than internally developed software, subject to amortization are summarized as of June 30, 2005 as follows:

| | **Weighted Average Remaining Amortization Period (Years)** | | **Gross Carrying Amount** | | **Accumulated Amortization** |
|---|---|---|---|---|---|
| Purchased technology | 5.3 | $ | 16,793 | $ | (1,669) |
| Customer relationships | 5.7 | | 13,477 | | (543) |
| Total | 5.5 | $ | 30,270 | $ | (2,212) |

Amortization expense, including impairment charges as a result of overlapping technologies associated with the Cedara transaction, was $1,356 for the six months ended June 30, 2005. An impairment charge for purchased technology of $67 was recorded in cost of goods sold and a charge for $610 related to customer relationships was recorded in operating expense. In addition, we recorded an impairment charge of $868 for capitialized development projects as a result of over lapping technologies for the six months ended June 30, 2005 in cost of goods sold. Estimated aggregate amortization expense for each of the next five years is as follows:

| | | | |
|---|---|---|---|
| For the remaining six months: | 2005 | $ | 2,872 |
| For the year ended December 31: | 2006 | $ | 5,198 |
| | 2007 | $ | 5,054 |
| | 2008 | $ | 4,705 |
| | 2009 | $ | 4,418 |

*(3) Income Per Share*

Basic earnings per share are computed by dividing income available to common shareholders by the weighted average number of shares outstanding. We have made an accounting policy election to use the if converted method for convertible securities that are eligible to participate in Common Stock dividends, if declared; however, the two class method must be used if the effect is more dilutive. Diluted earnings per share reflects the potential dilution that could occur based on the exercise of stock options, unless such exercise would be anti dilutive, with an exercise price of less than the average market price of our Common Stock. The following table sets forth the computation of basic and diluted earnings per share for the three and six months ended June 30, 2005 and 2004.

| | Three Months Ended June 30, 2005 | Three Months Ended June 30, 2004 | Six Months Ended June 30, 2005 | Six Months Ended June 30, 2004 |
|---|---|---|---|---|
| Numerator: | | | | |
| Net income (loss) | $ (11,877) | $ 1,497 | $ (9,781) | $ 2,851 |
| Accretion of redemption value related to exchangeable shares | | | | (1) |
| Allocation of income to exchangeable shares | | | | (1) |
| Numerator for net income (loss) per shares basic and diluted | $ (11,877) | $ 1,497 | $ (9,781) | $ 2,849 |
| | | | | |
| Denominator: | | | | |
| Weighted average number of shares of Common Stock outstanding | 19,254,640 | 12,968,889 | 16,248,205 | 12,927,877 |
| | | | | |
| Effect of stock options | | 813,551 | | 846,103 |
| Denominator for net income per share diluted | 19,254,640 | 13,782,440 | 16,248,205 | 13,773,980 |
| | | | | |
| Net income (loss) per share basic | $ (0.62) | $ 0.12 | $ (0.60) | $ 0.22 |
| Net income (loss) per share diluted | $ (0.62) | $ 0.11 | $ (0.60) | $ 0.21 |

The weighted average number of shares of Common Stock outstanding used to calculate basic net loss per share includes exchangeable share equivalent securities for the three and six months ended June 30, 2005 of 4,209,834 shares and 2,116,546 shares, respectively, and for the three and six months ended June 30, 2004 of 332,698 and 334,421, respectively.

For the three months ended June 30, 2005 and 2004, options to purchase 1,282,530 shares and 43,000 shares, respectively, of our Common Stock had exercise prices greater than the average market price of the shares of Common Stock, and therefore not included in the above calculations of net income (loss).

For the six months ended June 30, 2005 and 2004, options to purchase 45,650 shares and 130,000 shares, respectively, of our Common Stock had exercise prices greater than the average market price of the shares of Common Stock, and therefore not included in the above calculations of net income (loss).

As a result of the loss during the three and six months ended June 30, 2005, incremental shares from the assumed conversion of employee stock options totaling 1,045,278 shares and 921,663 shares, respectively, have been excluded from the calculation of diluted loss per share as their inclusion would have been anti dilutive.

*(4) Stock Based Compensation*

We maintain four stock based employee compensation plans and one director option plan. We apply the provisions of Statement of Financial Accounting Standards ( SFAS ), SFAS No. 123, *Accounting for Stock Based Compensation*, as amended ( SFAS No. 123 ), which requires entities to recognize as expense over the vesting period the fair value of all stock based awards on the date of grant. Alternatively, SFAS No. 123 allows entities to continue to apply the provisions of Accounting Principles Board ( APB ) Opinion No. 25, *Accounting for Stock Issued to Employees* ( APB Opinion No. 25 ) and provide pro forma disclosures as if the fair-value-based method defined in SFAS No. 123 had been applied.

We have elected to continue to apply the provisions of APB Opinion No. 25 in accounting for our plans. All stock options under the plans have been granted at exercise prices of not less than the market value at the date of grant, and as a result, no compensation expense has been recorded under APB Opinion No. 25. Had we determined compensation cost based on the fair value at the grant date under SFAS No. 123, our net income (loss) would have been decreased, to the pro forma amounts indicated below:

| | Three Months Ended June 30, 2005 | Three Months Ended June 30, 2004 | Six Months Ended June 30, 2005 | Six Months Ended June 30, 2004 |
|---|---|---|---|---|
| Net income (loss), as reported | $ (11,877) | $ 1,497 | $ (9,781) | $ 2,851 |
| Add: Stock based employee compensation expense included in reported net income (loss), net of related tax benefits | 99 | | 99 | |
| Deduct: Total stock-based employee compensation expense determined under fair-value-based method for all awards, net of related tax benefits | (714) | (225) | (910) | (407) |
| Pro forma net income (loss) | $ (12,492) | $ 1,272 | $ (10,592) | $ 2,444 |
| Earnings (loss) per share: | | | | |
| Basic as reported | $ (0.62) | $ 0.12 | $ (0.60) | $ 0.22 |
| Basic pro forma | $ (0.65) | $ 0.10 | $ (0.65) | $ 0.19 |
| Diluted as reported | $ (0.62) | $ 0.11 | $ (0.60) | $ 0.21 |
| Diluted pro forma | $ (0.65) | $ 0.09 | $ (0.65) | $ 0.18 |

*(5) Acquisitions*

*(a) Cedara*

*Business Combination*

On June 1, 2005, we completed our business combination with Cedara, a leader in the development of custom engineered software applications and development tools for the medical imaging OEM and international markets. The transaction was announced on January 17, 2005 upon the execution of a definitive agreement and closed on June 1, 2005, following approval by both Merge and Cedara shareholders and receipt of necessary regulatory approvals. The business combination was effected through an exchange of stock, in which Cedara shareholders received 0.587 shares of our Common Stock for each share of Cedara Common Stock. Also, Cedara shareholders who are Canadian residents were permitted to receive either our Common Stock or newly created exchangeable shares of our wholly owned subsidiary Merge Cedara ExchangeCo Limited ( ExchangeCo Exchangeable Shares ). Canadian residents who received ExchangeCo Exchangeable Shares in the transaction defer paying income taxes on the transaction until such time as they exchange the shares for Common Stock or otherwise dispose of them. The ExchangeCo Exchangeable Shares are freely tradable on the Toronto Stock Exchange (TSX) under the ticker symbol MRG. The ExchangeCo Exchangeable Shares are exchangeable into shares of Merge Common Stock at any time at the option of the holder. Holders of Cedara stock options exchanged each such Cedara option for a 0.587 Merge option, and we adjusted strike prices for the stock and currency conversion rates, with no changes to the vesting terms of the option. We issued approximately 1.9 million replacement options as a result of this exchange.

*Reasons for the Transaction*

The business combination with Cedara places us as a market leader in the development and delivery of medical imaging and information management software and services for the OEM market and end user imaging centers, and small to medium hospitals. Cedara has a substantial customer base and experienced continued sales growth over past few years. As a result, we issued stock in the Cedara transaction at a premium, based on the price of the Cedara stock price prior to the date of announcement.

*Purchase Accounting*

The transaction consideration was valued at approximately $387,072, including the exchange of approximately 18.8 million equivalent shares at a market price of $18.97 per share, estimated fair value for outstanding options at the date of closing and direct transaction costs incurred by us. The fair value of stock issued is based upon the 0.587 exchange ratio and a four day weighted average of our stock price two days prior, the day of and one day after the announcement based on NASDAQ closing prices. The fair value of the outstanding options are estimated at approximately $25,211 based on a 1.247 U. S. Dollar to Canadian dollar currency exchange ratio, the 0.587 exchange ratio and on the four day weighted average indicated above. The estimated total purchase price is as follows:

| Form of Consideration | | Fair Value |
|---|---|---|
| Stock issued | $ | 356,478 |
| Estimated fair value of options assumed | | 25,211 |
| Direct transaction costs | | 5,383 |
| Total consideration | $ | 387,072 |

The acquisition was accounted for using the purchase method of accounting. Merge was considered the accounting acquirer in the business combination, requiring the purchase consideration to be allocated to Cedara s net tangible and intangible assets based on their respective fair values as of the date of transaction close, with the residual reflected as goodwill. Due to the timing of the closing of the business combination with Cedara, we have preliminarily allocated the purchase price to Cedara s assets and liabilities and expect the allocation to change in future reporting periods. The allocation of the purchase consideration is based in part upon a valuation of the intangible assets performed by independent valuation specialists, primarily through the use of discounted cash flow techniques. The estimated purchase price allocation, based on Cedara s assets and liabilities as of June 1, 2005, is as follows:

| | | Fair Value |
|---|---|---|
| Assets acquired | $ | 36,466 |
| Liabilities assumed | | (16,719) |
| Purchased and developed technologies | | 13,177 |
| Customer relationships | | 12,500 |
| In-process research and development | | 12,989 |
| Deferred stock compensation | | 2,132 |
| Goodwill, including trade names | | 326,527 |
| Total consideration | $ | 387,072 |

The amounts allocated to in process research and development, purchased and developed software and customer relationships are estimated based on the work performed by independent valuation specialists. The estimated fair value of the purchased and developed software was determined by the utilization of a combination of the excess earnings and relief from royalty approaches. The estimated fair value of the customer relationships was determined by the utilization of the cost savings approach. Appraisal assumptions utilized under these methods included a forecast of estimated future net cash flows, as well as discounting the future net cash flows to their present value. We used a 17% discount rate for both purchased and developed software and customer relationships, which was calculated using an industry beta and capital structure. These amounts are being amortized over a six year period. The estimated asset lives were determined based on projected future economic benefits and expected life cycles of the technologies and customer relationships.

The amount assigned to goodwill includes $8,545 associated with trade names and is not being amortized, but will be tested for impairment annually or under certain circumstances that may indicate a potential impairment.

The value assigned to acquired in process technology was determined by identifying the acquired specific in process research and development projects that would be continued, and for which (1) technological feasibility had not been established at the acquisition date, (2) there was no alternative future use, and (3) the fair value was estimable with reasonable reliability. The nature of the efforts to develop the in process technology into the commercially viable products are expected to principally relate to the completion of all planning, designing, prototyping, verification and testing activities that are necessary to establish that the technology can be produced to meet its design specification, including function, features, and technical performance requirements. At the date of the business combination, Cedara had in process projects meeting the above definition associated with the Cedara next generation PACS workstation, OEM imaging platforms and image acquisition console projects.

We estimated the fair value of the Cedara projects to be $12,989, based on the work performed by independent valuation specialists. Accordingly, this amount was immediately expensed in the consolidated statement of operations upon the acquisition date. The estimated fair value of the Cedara projects was determined by the utilization of the excess earnings approach. Appraisal assumptions utilized under this method included a forecast of estimated future net cash flows, as well as discounting the future net cash flows to their present value. We used a 20% discount rate, which was calculated using an industry beta and capital structure.

The $2,132 allocated to deferred stock compensation is valued based on the intrinsic value of each outstanding and unvested stock option assumed on the closing date. The charge for stock compensation for the three and six months ended June 30, 2005 was $129 and is classified in the statement of operations based on each applicable employee s position. Estimated aggregate expense for each of the next five years is as follows:

| | | | |
|---|---|---|---|
| For the remaining six months: | 2005 | $ | 773 |
| For the year ended December 31: | 2006 | | 849 |
| | 2007 | | 317 |
| | 2008 | | 64 |
| | 2009 | | |

The $326,527 assigned to goodwill and $12,989 estimated fair value of in process research and development will not be deductible for federal income tax purposes.

*Pro forma Results*

As discussed in Note 1, the results of Cedara have been included in the consolidated financial statements since June 1, 2005.

The following unaudited pro forma condensed combined results of operations for the three and six months ended June 30, 2005 and 2004 are based on the historical financial statements of Merge and Cedara giving effect as if the business combination had occurred at the beginning of the periods presented. Therefore, this pro forma data has been adjusted to exclude Cedara pre acquisition intangible amortization and the in process research and development expense while including amortization of intangible assets and expense of deferred stock compensation during the entire applicable periods. This data also reflects only the historical Merge and Cedara tax expense. This data is not indicative of the results of operations that would have arisen if the transaction had occurred at the beginning of the respective periods. Moreover, this data is not intended to be indicative of future results of operations.

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | **2005** | **2004** | **2005** | **2004** |
| Revenue | $ 23,721 | $ 19,716 | $ 54,202 | $ 38,560 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Net income (loss) from continuing operations | | (6,192) | | 3,710 | | 96 | | 7,564 |
| Earnings (loss) per share: | | | | | | | | |
| Basic | $ | (0.16) | $ | 0.12 | $ | 0.00 | $ | 0.24 |
| Diluted | $ | (0.16) | $ | 0.11 | $ | 0.00 | $ | 0.22 |

*Restructuring and Other Charges*

In connection with the business combination and our related synergy goals, we have incurred charges in the three months ended June 30, 2005 that are unusual to our operations.  As such, we have separately classified these charges within operating expenses.  Restructuring charges are comprised of severance to Merge involuntarily terminated employees of approximately $152 and option acceleration expense of $37, based on the intrinsic value of the options at the time of termination.  At June 30, 2005, accrued restructuring charges of $74 remain to be paid.  Costs associated with involuntarily terminated employees of Cedara have been accrued for and included in the estimated value of liabilities assumed.

Other charges of $400 relate to an impairment of certain current assets based on a change in the estimated recoverability of the related assets due to a triggering event not associated with the Cedara transaction.

*ExchangeCo Exchangeable Shares*

Each holder of ExchangeCo Exchangeable Shares has the right, at any time prior to April 30, 2010, to exchange their shares for our Common Stock on a one for one basis, subject to adjustment provisions.  At April 30, 2010, any remaining exchangeable shares will be redeemed and exchanged for an equivalent number of shares of our Common Stock.  Certain circumstances exist in which we have the right to require an exchange of the ExchangeCo Exchangeable Shares prior to April 30, 2010.  Each exchangeable share, through a trust agreement and special voting stock, is entitled to vote together with our Common Stock and be included in dividend rights equivalent to our Common Stock as indicated by the one share of Series 3 Special Voting Preferred stock, no par value, issued and outstanding at June 30, 2005.

*(b) AccuImage*

On January 28, 2005, we acquired all of the outstanding capital stock of AccuImage in an all cash transaction.  The total purchase price for the acquisition was $6,978.  AccuImage has been in the business of the development, marketing and support of software for advanced visualization, analysis and management of medical imaging data from medical imaging modalities.

We paid a significant premium above the fair value of AccuImage s tangible net assets principally because we determined that AccuImage s software development ability and advanced visualization products will contribute to future products offered to our end user customers.  As we look to the future, we foresee the need to expand our software product offerings to healthcare institutions and imaging centers to include advanced visualization tools.

An escrow of $1,000 of the purchase price was established as a reserve for 24 months, which will terminate on January 28, 2007, against any claims regarding breaches of representations and warranties as well as adjustments to the net asset value of the AccuImage balance sheet at the date of closing.

The acquisition was accounted for using the purchase method of accounting and is considered an insignificant acquisition.  The accompanying consolidated statements of operations include the results of operations for AccuImage since the acquisition date, January 28, 2005.  The amount allocated to purchased and developed software and customer relationships are being amortized over a five year period. The estimated asset lives were determined based on projected future economic benefits and expected life cycles of the technologies and customer relationships. The amount assigned to goodwill is not being amortized, but will be tested for impairment annually or under certain circumstances that may indicate a potential impairment. The following is a summary of purchase consideration for the acquisition of AccuImage:

| Form of Consideration | | Fair Value |
|---|---|---|
| Cash | $ | 5,848 |
| Debt assumed and paid | | 1,012 |
| Transaction costs | | 118 |
| Total consideration | $ | 6,978 |

The following table represents the allocation of the total purchase consideration for the purchase of AccuImage. The allocation of the purchase consideration is based in part upon an independent valuation.

| | | Fair Value |
|---|---|---|
| Assets acquired | $ | 1,043 |
| Purchased and developed technologies | | 763 |
| Customer relationship | | 80 |
| Goodwill | | 4,805 |
| Deferred tax asset | | 676 |
| Liabilities assumed | | (1,401) |
| Debt assumed and paid | | 1,012 |
| Total consideration | $ | 6,978 |

The $4,805 assigned to goodwill in the acquisition will not be deductible for federal income tax purposes. We have not included pro forma results of operations for AccuImage as it is considered an immaterial acquisition.

As a result of the Cedara transaction, there exists overlapping technologies, which lead to the write off in the quarter ended June 30, 2005 of approximately $73 of purchased and developed technologies. In addition, a trigger event, outside of our control, occurred which resulted in the write off of the $80 customer relationship during the quarter ended June 30, 2005.

*(6) Commitments and Contingencies*

On October 24, 2003, ScheduleQuest, Inc. filed a patent infringement lawsuit (Civil Action No. 03 5900) against us in the United States District Court for the Eastern District of Pennsylvania alleging that our RIS Logic CS Scheduling System product infringes upon their United States of America Patent No. 6,389,454 for their Multi Facility Appointment Scheduling System product, which we acquired in connection with our RIS Logic acquisition. We cannot currently predict the outcome of the litigation or the amount of any potential loss if our defense is unsuccessful. Our merger agreement with RIS Logic contains a representation that the RIS Logic technology does not infringe others proprietary rights and 173,093 shares of our Common Stock conveyed to the former RIS Logic owners are in an escrow holdback, which has been extended to August 15, 2005, to cover any claims of breach of representation or warranty. We believe that all the claims in the lawsuit are without merit and we intend to vigorously defend against such claims. However, we cannot provide any assurances as to the outcome of this litigation or whether the escrow holdback will be adequate to satisfy any costs, expenses or losses that we may incur in connection with such litigation.

We are involved in disputes and legal actions arising in the ordinary course of business. We have determined, based on review with legal counsel, that certain disputes or legal actions have a more than likely possibility of loss and have recorded an estimated expense of $225 during the quarter ended June 30, 2005. However, litigation is subject to inherent uncertainties, and an adverse result in such matters may arise from time to time that may harm our business or actual results may be in excess of that for which we have recorded.

As indicated in Note 5, we have incurred certain costs associated with involuntarily terminated employees of Cedara which have been accrued for and included in the estimated value of liabilities assumed. At June 30, 2005, there exist approximately $1,500, based on a present value using a 6% discount rate, of remaining severance payments for two individuals, as required under the transaction agreement, which will be made over a period of approximately two years. All other severance related payments existing at June 30, 2005 are payable within ten months of the close date.

*(7) Shareholder s Equity*

On May 24, 2005, our shareholders approved an amendment to our Articles of Incorporation to increase the number of authorized shares of Common Stock from 30 million to 100 million.

In addition, our shareholders approved the 2005 Equity Incentive Plan ( EIP ). The EIP provides for awards of Common Stock, non statutory stock options, incentive stock options, stock unit and performance unit grants and stock appreciation rights to eligible participants to equate to a maximum of 7.5 million shares of Common Stock, of which incentive stock option grants are limited to 5 million shares. Under the EIP, stock options have an exercise price equal to the fair market value of our Common Stock at the date of grant. No additional shares will be issued under our two existing employee stock option plans or director option plan.

*(8) Recent Accounting Pronouncements*

In December 2005, the FASB issued SFAS No. 123(R), *Share Based Payment*, ( SFAS No. 123(R) ) to be effective for interim or annual periods beginning after June 15, 2005. On April 14, 2005, the Securities and Exchange Commission amended the compliance dates to require SFAS No.123(R) to be effective for fiscal years beginning after June 15, 2005. SFAS No. 123(R) revises SFAS No. 123 and supersedes APB Opinion No. 25 and requires all share based payments to employees, including grants of employee stock options, to be recognized as an expense in the statement of operations. The cost will be recognized over the requisite service period based on fair values measured on the respective grant dates. We will adopt the new standard using the modified prospective transition method, which permits recognition of expense on or after the effective date for the portion of outstanding awards for which the requisite service has not yet been rendered. The adoption of SFAS 123(R) will result in additional expense being recorded beginning in 2006 related to our share based employee compensation programs. We are in the process of evaluating the impact of the adoption of SFAS No. 123(R).

In June 2005, the FASB issued FASB Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations*, which is an interpretation of FASB Statement No. 143, *Accounting for Asset Retirement Obligations*. The interpretation requires a liability for the fair value of a conditional asset retirement obligation be recognized if the fair value of the liability can be reasonably estimated. The interpretation is effective for fiscal years ending after December 15, 2005. The interpretation is not expected to have a material impact on our results of operations or financial position.

*(9) Income Taxes*

As part of the process of preparing our consolidated financial statements, we are required to estimate income taxes in each of the jurisdictions in which we operate. This process involves estimating our current tax rate together with assessing temporary differences resulting from differing treatment of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities. We must then assess the likelihood that our deferred tax assets will be recovered from future taxable income, and to the extent that we believe that recovery is not likely, we must establish a valuation allowance. To the extent we establish a valuation allowance or increase or decrease this allowance in a period, we must include the tax effect within the tax provision as an adjustment to goodwill or in the statement of operations, as applicable. Significant management judgment is required in determining our provision for income taxes, deferred tax assets and liabilities and any valuation allowance recorded against our net deferred tax assets. We are still in the process of completing our evaluation of the deferred tax assets, including a full valuation allowance for the Canadian deferred tax assets, and liabilities associated with the Cedara transaction. As a result, the amounts estimated to compute fair value for such items may change.

Our effective tax rate for the second quarter is based upon the estimated purchase accounting for the business combination with Cedara and may be adjusted as the purchase accounting is finalized.

The income tax expense for the three months ended June 30, 2005 varies from the amount computed by applying the statutory federal income tax rate of 34% to operating income before income tax expense primarily due to state income taxes, net of federal income tax effect, and adjustments for permanent book to tax differences, the most significant in the three months ended June 30, 2005 being the write off of in process research and development acquired in the Cedara transaction, as required under United States of America generally accepted accounting principles, which is not deductible for income tax purposes.

Our expected effective income tax rate is volatile and may move up or down with changes in, among other items, operating income, the results of our purchase accounting, and changes in tax law and regulation of the United States of America and foreign jurisdictions in which we operate.

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

**Special Note on Forward Looking Statements**

Certain statements in this report that are not historical facts constitute forward looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act ). Discussions containing such forward looking statements may be included herein in the material set forth under *Management s Discussion and Analysis of Financial Condition and Results of Operations,* as well as within this report generally. In addition, when used in this report, the words: *believes, intends, anticipates, expects* and similar expressions are intended to identify forward looking statements. These statements are subject to a number of risks and uncertainties, including, among others and in addition to those listed under *Factors That May Affect Future Results of Operations, Financial Condition or Business*, quarterly operating results may vary, our stock price may be volatile, changes in the healthcare industry, significant competition, dependence on key employees, government regulation, product related liabilities, risk associated with global operations, concentrations, new regulations relating to patient confidentiality, system errors and warranties, limited protection of intellectual property and property rights, our proprietary technology may be subjected to infringement claims, we may be unable to successfully integrate acquisitions, and various other competitive factors that may prevent us from competing successfully in the marketplace. Actual results could differ materially from those projected in the forward looking statements. We undertake no obligation to publicly release the result of any revisions to these forward looking statements that may be made to reflect any future events or circumstances. Our actual results and the timing of certain events may differ materially from those reflected in the forward looking statements. The following discussion should be read in conjunction with the consolidated financial statements and notes thereto appearing elsewhere in this report.

**Overview**

On June 1, 2005, we completed our business combination with Cedara, including its subsidiary eMed Technologies Incorporated, now known as Merge eMed ( eMed ). Subsequent to the Cedara transaction, the name under which we do business as was changed from Merge eFilm to Merge Healthcare. There are two organizational groups within Merge Healthcare: Merge eMed, which serves the end user market comprised of hospitals, imaging centers and specialty clinics; and Cedara Software, which serves the OEM/VAR (value added resellers) and international markets comprised of companies that develop, manufacture or resell medical imaging software or devices.

Merge Healthcare is a market leader in the development and delivery of medical imaging and information management software and services. With over twenty years of leadership in the medical imaging and healthcare information technology markets, Merge Healthcare provides innovative solutions for both OEM and the end user healthcare markets. We develop innovative medical imaging software solutions that support end to end business and clinical workflow for radiology department and specialty practices, imaging centers and hospitals. Our innovative software solutions use leading edge imaging software technologies that accelerate market delivery for our OEM and international customers, while our end user solutions improve our customers productivity and enhance the quality of patient care they provide.

Merge eMed focuses on the United States of America end user market, and is a leading provider of Picture Archiving and Communications Systems ( PACS ), Radiology Information System ( RIS ), and clinical medical imaging software applications. Our products link business and clinical workflow by intelligently managing and distributing diagnostic images and information throughout the healthcare enterprise, and providing visualization tools that speed the productivity and enhance the clinical accuracy of the diagnosis of general and specialty medical imaging exams. By utilizing our products, our customers enhance the quality of healthcare provided to patients because they improve radiology workflow efficiencies and improve the clinical decision making processes. In addition, our products reduce the film, paper and labor costs involved in managing and distributing medical images and information, thereby contributing to the profitability of our customers businesses. We deliver this tangible value to facilities of all sizes, but we specifically target imaging centers, small to medium size hospitals, and specialty clinics.

Cedara Software is focused on the development of custom engineered software applications and development tools for the medical imaging OEM and international markets. Cedara Software is deployed in hospitals and clinics worldwide and is licensed by many of the world s leading medical device and healthcare information technology companies. Cedara Software technologies and expertise span all the major digital imaging modalities including computed tomography (CT), magnetic resonance imaging (MRI), digital X ray, mammography, ultrasound, echo cardiology, angiography, nuclear medicine, positron emission tomography (PET), and fluoroscopy. Cedara Software s medical imaging offerings are used in all aspects of clinical imaging workflow including the capture of a patient s digital image; the archiving, communication and manipulation of digital images; sophisticated clinical applications to analyze digital images; and the use of imaging in minimally invasive surgery.

We have expanded our product offering, especially in the past three years, through our acquisitions of eFilm, RIS Logic, Inc. ( RIS Logic ), and AccuImage, and business combination with Cedara and eMed. We became a full PACS provider in September 2002 through our acquisition of eFilm, which provided a visualization platform, that combined with our existing PACS components to allow us to release our first integrated PACS system for the small and medium sized hospital and imaging center market. The eFilm Workstation™ also is core to our strategy to own the clinician desktop market. We sell our eFilm Workstation™ on the Internet, for either an annual subscription or for an unlimited time based license fee. This strategy allows those radiologists or clinicians who are reluctant to move to reading images digitally to do so easily and inexpensively, particularly relative to other similar clinical diagnostic tools on the market. Our July 2003 acquisition of RIS Logic allowed us to become one of the first providers of integrated RIS/PACS solutions in our target markets. We saw this as a growing need of our target market. The integrated RIS/PACS solution positions us to fundamentally own the technology necessary to run an imaging center by having the PACS deliver film less workflow and the RIS deliver paperless workflow. Our January 2005 acquisition of AccuImage allowed us to provide advanced visualization product offerings to healthcare institutions and imaging centers. In addition, it will allow us to become one of the first providers of integrated visualization solutions offered on other than on a stand alone workstation basis, which we see as a growing need of our target market. With the June 2005 business combination with Cedara, we became the leading medical imaging OEM company, simultaneously delivering a high end innovation for our expanded PACS market share.

Our combination with Cedara and eMed into a single entity makes us unique in the industry as the only medical imaging/healthcare information technologies ( IT ) company serving our target market that creates imaging software for newly developing technologies with its OEM customers, and can ensure that those future technologies, when introduced into the marketplace, can effectively be incorporated in clinical and operational workflow of imaging centers, hospitals and specialty clinics. This unique ability benefits our end user customers businesses, growing their referral base by providing leading edge clinical diagnoses and time saving systems to access them, and improving their profitability by accelerating productivity and optimizing their investments in imaging equipment and IT systems. We believe the combined innovation model between our OEM medical imaging engineering and our RIS/PACS/Clinical Application offerings position Merge Healthcare well among our competitors for future success.

**Our Market**

Healthcare providers continue to be challenged by declining reimbursements, competition and reduced operating profits brought about by the double digit increases in healthcare expenditures in the past several years. In the United States of America, we are focusing our direct sales efforts on single and multi site imaging centers with more than 10,000 studies per year, small to medium sized hospitals (fewer than 400 beds), and certain specialty clinics like orthopedic practices that offer imaging services. Frost & Sullivan also reported the following marketplace information:

PACS revenues totaled $1.0 billion in 2003;

The total market is expected to reach $2.0 billion in 2010;

The fastest growth is occurring in community hospitals and high volume imaging centers;

Community hospitals and high volume imaging centers are expected to become the largest market segments by the end of the forecast period; and

PACS upgrades/migrations have also become a major sub segment of the market.

The market for our products is highly competitive. Some customers purchase products both from us and from our competitors. In the developing area of RIS and PACS workflow software applications, there are many newly emerging competitors who offer portions of the integrated radiology solution through their RIS and PACS to our target market. Additionally, certain competitors are integrating RIS and PACS technologies through development, partnership and acquisition activities. However, we do not believe that any other competitor that specifically serves our target market is able to offer the combined RIS, PACS and clinical applications that are developed and integrated by a single vendor, providing customers with a single system that yields strong productivity gains, attracts referrals from primary care and specialty physicians, and eases operations by having only a single vendor relationship to manage.

**Significant Events in the Three Months Ended June 30, 2005**

During the three months ended June 30, we continued to focus on a core set of strategic and operational objectives designed to reinforce our market leading position in medical imaging and achieve our financial goals. We continue to see accelerating interest from our target market for a comprehensive software solution from a