MERGE TECHNOLOGIES INC
Form 10-K
August 30, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2005

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

For the transition period from to

Commission file number 0-29486

MERGE TECHNOLOGIES INCORPORATED

(Exact name of Registrant as specified in its charter)

Wisconsin	**39-1600938**
(State or other jurisdiction of incorporation or organization)	(I. R. S. Employer Identification No.)

6737 West Washington Street, Suite 2250, Milwaukee, Wisconsin 53214-5650
(Address of principal executive offices, including zip code)
(Registrant s telephone number, including area code) **(414) 977-4000**
Securities registered under Section 12(b) of the Exchange Act:
Common Stock, $0.01 par value per share
(Title of class)
Securities registered under Section 12(g) of the Exchange Act: **NONE**

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act

Yes o No x

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

Yes o No x

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 o No x

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer o Accelerated filer x Non-accelerated filer o

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

Yes o No x

The aggregate value for the Registrant s voting and non-voting common equity held by non-affiliates of the Registrant as of June 30, 2005, based upon the closing sale price of the Common Stock on June 30, 2005, as reported on the NASDAQ Global Market, was approximately $378,166,275. Shares of Common Stock held by each officer and director and by each person who owns ten percent or more of the outstanding Common Stock have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

The number of shares outstanding of the Registrant s common stock, par value $0.01 per share, as of August 22, 2006: 29,069,624

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MERGE TECHNOLOGIES INCORPORATED

EXPLANATORY NOTE RESTATEMENT OF FINANCIAL INFORMATION

This Annual Report on Form 10-K for the year ended December 31, 2005, includes (1) a restated balance sheet as of December 31, 2004, (2) restated consolidated statements of operations, consolidated statements of shareholders equity, consolidated statements of cash flows and consolidated statements of comprehensive income for the years ended December 31, 2003 and 2004, (3) restated quarterly financial information for the quarters ended March 31, 2005 and 2004, June 30, 2005 and 2004 and September 30, 2005 and 2004, and (4) restated selected financial data for the years ended December 31, 2002, 2003 and 2004. The Company will not file amended periodic reports for any of the affected periods. See Item 6, Selected Financial Data, Item 8, Financial Statements and Supplementary Data, and Item 9A, Controls and Procedures, in Part II of this Annual Report on Form 10-K, including Footnotes 12 and 13 to the notes to consolidated financial statements, for more information concerning these restatements. This Annual Report on Form 10-K should be read in conjunction with our Quarterly Report on Form 10-Q for the quarter ended March 31, 2006, which is being filed contemporaneously with this Form 10-K.

PART I

Item 1. BUSINESS

Cautionary Note Regarding Forward-Looking Statements

Certain statements in this report that are not historical facts, including, without limitation, statements that reflect our current expectations regarding our future growth, results of operations, performance, business prospects and opportunities, constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933, and Section 21E of the Securities Exchange Act of 1934. When used in this report, the words believes, intends, anticipates, expects, will and similar expressions are intended to identify forward-looking statements, but are not the exclusive means of identifying them. These statements are based on information currently available to us and are subject to a number of risks and uncertainties that may cause our actual growth, results of operations, financial condition, cash flows, performance, business prospects and opportunities and the timing of certain events to differ materially from those expressed in, or implied by, these statements. These risks, uncertainties and other factors include, without limitation, those matters discussed in Item 1A, Risk Factors in Part I of this Annual Report on Form 10-K. Except as expressly required by the federal securities laws, we undertake no obligation to publicly update these factors or any of the forward-looking statements to reflect future events, developments or changed circumstances, or for any other reason.

Overview

Merge Technologies Incorporated, a Wisconsin corporation doing business as Merge Healthcare, and its subsidiaries or affiliates (Merge Healthcare, we, us, or our), develops medical imaging and information management software and delivers related services. There are three principal sales and business development channels for Merge Healthcare: Direct, which generally sells to the United States of America (U.S.) end-user healthcare market comprised of hospitals, imaging centers and specialty clinics; OEM and International, which primarily sells to Original Equipment Manufacturers (OEMs) and Value Added Resellers (VARs), comprised of companies that develop, manufacture or resell medical imaging software or devices, and also to the international end-user healthcare market; and eCommerce which distributes certain products through the Internet via our website. Merge Healthcare is unique in the industry in its three-channel distribution methodology. Products and services developed throughout Merge Healthcare are sold via Direct, OEM/VAR and International, and eCommerce channels worldwide. This multiple channel approach was developed to optimize the sales of the products created throughout all of Merge Healthcare, resulting in a large portfolio of solutions that can be sold in the manner that best benefits our customers, and generates both upstream and downstream revenues for us.

On June 1, 2005, we completed our business combination with Cedara Software Corp., including its subsidiary eMed. Since the business combination with Cedara Software Corp., we have done business under the name Merge Healthcare, and have referred to our OEM/VAR and International channel as Cedara and our direct channel as Merge eMed.

We have over 20 years of leadership in the medical imaging and healthcare information technology markets, throughout which we have provided innovative solutions for OEMs, VARs and healthcare end-users. We develop clinical and medical imaging software applications and development tools that are on the forefront of medicine. We also develop medical imaging software solutions that support end-to-end business and clinical workflow for radiology department and specialty practices, imaging centers and hospitals. Our software technologies accelerate market delivery for our OEM customers, while our end-user solutions improve our customers productivity and enhance the quality of the patient experience. Our diagnostic imaging workflow applications are commonly categorized as Picture Archiving and Communication Systems (PACS), Radiology Information Systems (RIS) and Clinical Applications, which include, but are not limited to, software that supports medical imaging in many specialized areas

such as orthopaedics, cardiology, mammography and oncology. We believe the combination of RIS/PACS/Clinical Applications and Healthcare Information Management improves diagnostic imaging workflow. It also provides value by making images and other information available throughout the enterprise.

We directly provide PACS, RIS and clinical medical imaging software applications and also sell select products through our website s eCommerce engine. Our products and solutions link business and clinical workflow by managing and distributing diagnostic images and information throughout the healthcare enterprise, and providing visualization tools that target improved productivity and enhanced clinical accuracy of the diagnosis of general and specialty medical imaging exams. Our customers can enhance the quality of healthcare provided to patients because our solutions improve radiology workflow efficiencies and improve the clinical decision making processes. In addition, our solutions reduce the film, paper and labor costs involved in managing and distributing medical images and information, which helps drive increased profitability for our customers. We deliver value to many types of healthcare facilities of all sizes, but we specifically target imaging centers and specialty clinics.

We also focus on the development of custom-engineered software applications and development tools for the medical imaging and information OEM and International markets. Our software is deployed in hospitals and clinics worldwide through our partners and is licensed by many of the world s largest medical device and healthcare information technology (IT) companies as well as our Direct and eCommerce channels. Our technologies help our OEM customers increase revenues, create competitive advantages, and deliver technologies to end-user markets throughout the world. We may serve as an extended research and development team for the OEM, helping them to be first-to-market with innovative medical imaging technologies. We leverage our global end-user distribution channels to sell our customers existing technologies and applications, and expand the value of medical imaging solutions by licensing additional applications for our customers to sell through their own sales forces. Our 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. Our 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; the use of imaging in minimally-invasive surgery; and the management of patient information stored as Electronic Patient Records (EPR). We target OEM/VARs that serve all markets utilizing medical imaging in their businesses, regardless of the size or scope of the market they serve, including non-radiology markets such as oncology, pharmaceutical and EPR.

We have consistently expanded our suite of product and service offerings, particularly in the past four years. We see our RIS/PACS/Clinical Applications single-vendor approach as a unique advantage in our end-user target market. Additionally, we became a leading medical imaging OEM partner-company through our combination with Cedara Software Corp.

We believe the combined innovation model between our OEM medical imaging engineering and our RIS/PACS/Clinical Application offerings positions us uniquely among our competitors in the medical imaging and information markets, provides for a product innovation model that accelerates our development efforts by providing software-based technologies that can be embedded in solutions for the end-user market, and creates a product and distribution platform to allow us to explore new clinical and geographic markets beyond radiology. We believe that leveraging this unique innovation model and our ability to innovate new medical imaging solutions is key to our long term strategy to expand our products and services beyond the traditional boundaries of radiology.

Our Market

Millennium Research Group, an international market research firm, recently reported the following marketplace information:

- In 2005, the U.S. market for RIS and PACS, consisting of RIS and enterprise, radiology, orthopedic and cardiology PACS, was valued at over $1.5 billion.
- By 2010, this market will grow to over $3.0 billion, representing a compound annual growth rate of nearly 15%.
- Growth for the RIS market is primarily driven by imaging centers and small hospitals, particularly those that do not already have a PACS or RIS and elect for an integrated RIS/PACS solution.
- Growth for the PACS market is primarily driven by:
- adoption of EPR;
- growing customer receptiveness of PACS;
- the conversion from radiology to enterprise PACS solutions;
- customer demand for replacement PACS and integrated RIS/PACS solutions;
- affordable price points for small hospitals and imaging centers;
- growth in diagnostic capabilities for the cardiology market; and
- growth of in-office modalities in the orthopedic market.

The market for our end-user solutions is highly competitive. Healthcare providers continue to be challenged by declining reimbursements, intense competition and the increased cost of providing healthcare services. Some customers purchase products from us and from our competitors. In the developing area of RIS/PACS/Clinical Applications workflow, there are many newly emerging competitors that offer portions of an integrated radiology solution through their RIS, PACS and Clinical Applications. Additionally, certain competitors are integrating RIS, PACS and clinical applications through development, partnership and acquisition activities. However, we do not believe that any other competitor that specifically serves our end-user 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 yields enhanced support and technology migration by having only a single vendor relationship to manage.

Our OEM market, which consists of organizations that utilize medical imaging or information in any element of their business, is also highly competitive. Thousands of imaging-related prospective customers exist throughout the world. In addition, we utilize a Technology Partnership Program, where we work with academic researchers and entrepreneurial companies that have developed new, innovative medical imaging applications that are not yet fully commercialized. These technology partnerships further accelerate the innovation of our own technologies, allowing us to approach new clinical imaging markets outside of radiology. In exchange, we can offer our partner distribution channels, commercialization of their products, and an approach to OEM s globally that we have developed over the last 18 years. Working with these partners, we use our depth of medical imaging technology, global OEM distribution, and business expertise to commercialize and launch those products.

We believe that our innovation-driven model will enable us to proactively drive new demand for medical imaging solutions at both the OEM and end-user level. One of the main sources of competition for our OEM products is the OEM s own internal software development programs, where the customer may have the ability to utilize internal resources to create a similar technology or eventually replace our

software utilized in the customer s marketed solution. There are also a number of companies that specialize in one particular technology, which may compete with us in a selected market. However, we believe that there are no direct competitors in the OEM market that have the breadth of technologies, engineering resources and capabilities to compete with us in all aspects of our technology portfolio.

Recent Challenges

We continue to face significant business challenges that stem from the uncertainty created by changes in our senior management, announcements regarding our inability to meet requirements of the NASDAQ National Market (now designated the NASDAQ Global Market) for continued listing, an informal, non-public inquiry being conducted by the Securities and Exchange Commission and class action and other lawsuits. We believe that these matters have adversely affected the morale of our employees, our relationships with certain customers and potential customers and our reputation in the marketplace, and have diverted the attention of our Board of Directors and management from our business operations. We also have experienced challenges integrating the businesses and personnel of Merge Healthcare and Cedara Software Corp., which we acquired on June 1, 2005. In particular, we struggled to realize synergistic benefits as a consequence of organizational changes, primarily within our sales and service groups, following that business combination. In addition, since the business combination, we may not have devoted adequate resources to the development and acquisition of additional products. See Part I, Item 1A, Risk Factors, Part I, Item 3, Legal Proceedings, and Part II, Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations, to this Annual Report on Form 10-K for more detailed discussion regarding these matters.

History

Merge Technologies Incorporated, now doing business as Merge Healthcare, was founded in 1987 and built a reputation as a company that enabled the transformation of legacy radiology (film-based) images into modern (filmless) digitized images for distribution and diagnostic interpretation. We acquired eFilm Medical Inc. (eFilm) in June 2002 and began doing business under the name of Merge eFilm in order to leverage eFilm s international name recognition for diagnostic medical image workstation software with thousands of users worldwide. In July 2003, we acquired 100% of the outstanding shares of RIS Logic, Inc. (RIS Logic), a RIS company that designed software to manage business and clinical workflow for imaging centers that streamlines operations and accelerates productivity. We acquired AccuImage Diagnostics Corp. (AccuImage) in January 2005. AccuImage was founded from radiology academic research, and created products that utilized advanced visualization technologies for clinical specialty medical imaging. In June 2005, we completed our business combination with Cedara Software Corp. Cedara Software Corp. was established in 1982, bringing together some the world s most experienced medical imaging technology experts to create medical imaging software for OEM and VAR customers.

We believe our combined end-user and OEM capabilities position us uniquely as the only medical imaging/healthcare IT company that creates imaging software for new technologies being developed by our OEM customers, improving the likelihood that these new technologies, when introduced into the end-user marketplace, can effectively be incorporated in clinical and operational workflow of imaging centers, hospitals and specialty clinics. We believe that our end-user solutions improve our customers profitability by accelerating productivity and optimizing investments in imaging equipment and IT systems. We believe our OEM technologies improve our OEM customers profitability and decrease their time to market. We believe the combined innovation model of our OEM medical imaging engineering with our RIS/PACS/Clinical Application offerings positions us well among our competitors for future success.

We have consistently maintained a commitment to industry standards designed to benefit both healthcare providers and technology vendors. We have been a contributor to the development of the industry s standard network communications protocol known as Digital Imaging Communications in

Medicine (DICOM), open medical standards such as Health Level Seven, Inc. (HL7), and the Integrated Healthcare Enterprise (IHE) framework that has been created through an initiative cosponsored by the Radiological Society of North America (RSNA) and the Healthcare Information and Management Systems Society (HIMSS). The IHE initiative represents a consortium of companies in the Radiology and Healthcare Information Technology (HIT) fields. This set of requirements has paved the way for healthcare organizations to begin to integrate the complex workflow systems of the radiology department with the entire healthcare system by using equipment and software applications that connect the various image communication and information management components. We have incorporated these standards in our radiology workflow technologies, software applications and OEM connectivity components, establishing the basis for seamless integration of images and healthcare information across an organization s computing infrastructure.

How We Benefit Our Customers

Our end-user solutions benefit hospital radiology departments, diagnostic imaging centers, specialty clinics and their patients in a variety of ways, including:

- Accelerated productivity gained by utilizing a single integrated software solution for all business and clinical workflow tools designed to automate operations, including digital dictation, billing, registration and scheduling, productivity analysis, image and report management, and storage and distribution;
- Increased accuracy through real time patient demographic matching across all business and clinical workflow tools;
- More accountability and convenience in working with one vendor that develops, installs and supports the entire spectrum of radiology workflow tools and integration services;
- The creation of permanent electronic archives of diagnostic quality images that enable the retrieval of prior and current images and reports;
- Modular, flexible and cost-effective systems that can expand as the imaging center, hospital or clinic business grows;
- Networking of multiple image producing and image utilizing devices to eliminate redundancies and reduce the need for capital equipment expenditures or disaster recovery; and
- Optimizing image viewing and diagnostic capabilities.

Our OEM/International customers benefit from our software technologies and professional services in a number of ways, including:

- Using our technologies and services to enhance the workflow capabilities of their solutions;
- Accelerating the time to market in the development of new solutions;
- Creating greater product differentiation compared to their competitors; and
- Leveraging our technical and deployment skills, which facilitates an increased ability to focus on core competencies.

Business Strategy

We continue to build upon our position as an innovative medical imaging software and technology provider, and full solution RIS/PACS/Clinical Applications developer for the global healthcare end-user and OEM markets. We maintain this position by employing more than half of our employees in research and development activities, with total engineering costs, in thousands, of $13,535, $5,446 and $4,737 for

2005, 2004 and 2003, respectively, which includes capitalized software development costs and research and development expense. Our strong market position is the result of our expertise in clinical workflow and integration, technically innovative software products, modular software solutions, and continued focus on accelerating healthcare organizations productivity. Our OEM software technologies address the global market in medical imaging software innovation. Leveraging the clinical application innovation of our OEM products, we believe that our end-user products enable medical imaging and information to integrate more efficiently throughout the healthcare enterprise. By effectively utilizing our research and development activities, we can expand the solution set offered to both our OEM and end-user customers, accelerate the innovation of new products, and enter new markets such as orthopaedic, veterinary, pharmaceutical clinical trials, oncology and EPR. This strategy is the direct result of combining Cedara Software with Merge Healthcare, and forms the basis for our continued growth, innovation and new product and market development in the coming years.

During 2005, we focused our operational efforts on implementing an integration plan to yield revenue, product and operational synergies. We progressed with our next generation integrated RIS/PACS, utilizing its advanced features to enhance our value proposition to our customers. We focused on a web-based distribution solution to extend our RIS/PACS offering to referring physicians, strengthening our financial foundation, enhancing our sales and distribution channels, and leveraging the strength of our product brands. We also made steady progress in strengthening our reputation as a leading medical imaging workflow solution provider. We marketed and cross sold bundled products from across all of our combined product lines.

In line with this focused operational plan, we:

- Capitalized on opportunities within our existing OEM customer base by offering an expanded portfolio of medical imaging technologies, development platforms and products. This is evidenced by signing agreements with two customers, Toshiba Medical Systems Corporation and Hitachi Medical Corporation, that generated 16% and 10%, respectively, of our 2005 net sales;

- Expanded our U.S. healthcare RIS, PACS, RIS/PACS and Clinical Applications customer base to nearly 1,000 organizations, including over 700 end-user customers and over 275 OEM/VAR customers;

- Announced an expanded strategic agreement with Eklin Medical Systems, Inc., a veterinary imaging company;

- Received FDA 510(K) clearance for B-CAD, the first commercially available Computer Aided Detection (CAD) solution designed to assist radiologists in the analysis of breast ultrasound images;

- Announced agreement to provide Cedara B-CAD to Kodak as a part of its breast imaging suite;

- Released Cedara PET/CT Workstation as a software plug-in application available to OEM medical imaging companies and to healthcare professionals as a diagnostic software workstation that can be integrated into existing PACS and RIS/PACS solutions;

- Released a new version of our market leading diagnostic workstation, eFilm Workstation , and introduced clinical plug-in applications such as 3D/4D, virtual colonoscopy, calcium scoring, lung nodule analysis and image stitching;

- Released our next generation versions of RIS and RIS/PACS solutions; and

- Released Referring Practice Portal, an integrated web-based solution that provides referring physicians with real time access to patient information and status, medical images and reports.

We anticipate that any future growth will be driven primarily by a continued concentration on the following aspects of our business:

- Medical imaging innovation with our OEM partners, creating software applications, technologies and tools that optimize the growing and evolving capabilities of imaging acquisition devices such as multi-slice CT, PET, ultrasound and MRI;

- End-user sales initiatives, including targeted sales/marketing activities designed to achieve broader geographic coverage, expanded presence in other healthcare vertical markets and expanded product purchases from current customers;

- Clinical Application software and information systems development, both in partnership with OEM and technology partners and on a direct basis to end-users, providing growth opportunities globally and into new markets outside of radiology;

- Creating enhanced product offerings such as FUSION MATRIX PACS and FUSION RIS/PACS MX that expand the functionality of RIS/PACS to clinical applications beyond radiology; and

- Innovating technologies and solutions that serve new markets such as orthopaedic, veterinary, pharmaceutical clinical trials, oncology and EPR.

We believe our global presence and involvement in the creation of medical imaging software technologies and open medical standards places us in a strong position to monitor medical imaging industry and technological forces that impact both medical equipment and software application innovations. In addition, our established OEM/International relationships allow us to work with leading medical equipment manufacturers as they develop future plans for new product introductions. We sometimes partner with leading OEM companies in the design and development of new medical imaging software applications, and then incorporate those innovative medical imaging software modules within our integrated RIS/PACS solutions for sale on a direct basis to our end-user customers. This unique model of both OEM and end-user solution development accelerates our ability to innovate our products ahead of the needs of our current and future target markets.

End-User Products and Services Description

Focusing product innovation around the functions related to image and information management is a hallmark of our end-user product development strategy. We view our expertise as developing software that manages the people, process, images and information workflow in such a way as to increase productivity and reduce costs for our end-user customers. Products in place and those in development are applied to the complex continuum of business (billing, scheduling, modality management, practice analysis), image and information management (integrating results of CT, MRI, x-ray, etc., and the associated patient information related to them), interpretation and reporting (medical image visualization, analysis and management of medical imaging data, enhancing physicians interpretation and reporting of data from medical imaging modalities, such as computer tomography and magnetic resonance imaging), and the distribution of those reports and images to referring physicians. We believe that our solutions are differentiated by the integration of all of these elements, which enable us to create a broad data set around a single patient experience, combined with the capability for image interpretation using advanced tools for each specialty. The results are increased efficiency and productivity, more time devoted to accurate analysis and diagnosis, and ultimately improved patient care because the waiting time from diagnosis to treatment is reduced and all pertinent information is quickly and accurately provided to the primary care giver via the web, wherever the physician is located. This integrated solution with enterprise-wide accessibility to images and information reinforces our strategy of delivering end-to-end clinical and business workflow solutions that accelerate our customers productivity.

Our RIS and PACS offerings strengthened in 2005 as we began to make available clinical application technologies from our OEM group to our growing medical imaging software product suite. We have multiple solution offerings tailored to meet the needs of various market segments. For the international healthcare market, we have continued to offer two platforms under the FUSION PACS brand name based on Fusion eFilm PACS and Cedara I-Reach and Cedara I-Softview technologies. Our software modules are designed to allow continuous innovation of our fully integrated radiology workflow system product line and are sold as individual modules or as a fully integrated solution, depending on the needs of the customer. It is our intent to integrate our clinical application portfolio into our solution offerings thereby providing even more accelerated productivity as medical imaging moves beyond radiology. Our product innovation team is working closely with our customers to develop next generation products for our RIS, PACS, RIS/PACS and OEM product lines. In addition, our software development team is engineering various clinical application and advanced visualization software modules into our RIS/PACS workflow solutions, further changing and enhancing the traditional definition of RIS/PACS. These products can be sold throughout the world, and distributed through our OEM/International, Direct and eCommerce channels.

OEM Products and Services Descriptions

Software development can be accelerated by building applications on a software technology platform consisting of libraries and tools. We developed a software imaging platform, called Imaging Application Platform® (IAP), which has been used to develop imaging technologies and products for sale to OEMs and VARs, as well as licensed to these customers as a platform for their development of custom applications. Building on the success of IAP, we have created additional software engineering tools and platforms, including Cedara OpenEyes and Cedara Blue Print , which provide support for rapid application development. IAP, the middleware between applications, provides a complete software development environment with technology and capabilities for creating advanced, high-performance medical imaging applications. IAP is one of the most widely used medical imaging platforms available with a proven track record in all the major imaging modalities and clinical applications. All of our major OEM partners and virtually all of their engineering service clients, directly or indirectly, use IAP in business critical applications.

Our most advanced imaging software platform, Cedara OpenEyes, is a powerful and flexible best practices development platform that enables the rapid creation of medical applications. Its programming model represents a paradigm shift from previous technologies, completely insulating clients from the complexities of deep code development by providing a single uniform set of controls and development interfaces. Cedara OpenEyes packages connectivity, visualization and printing services in a flexible and transparent architecture that can be deployed across a wide spectrum of application environments, from small one-off projects to complex web solution services. Bringing further capability to Cedara OpenEyes, Cedara BluePrint provides advanced structure and application component support for software development.

Our OEM group also offers a full spectrum of PACS solutions, workstations and plug-in modules that can easily be tailored to the needs of different OEM customers. In addition, we develop image acquisition console software for companies that need a workstation to drive the capture of images from imaging devices such as x-ray or CT scanners.

Clinical applications software can have a major impact on the delivery of patient care. In the past several decades, a rapid expansion of clinical software systems has been noted within institutions that deliver healthcare. Today, more physicians rely on clinical applications to help them make even routine diagnostic and therapeutic decisions. Our broad range of clinical applications are used in general radiology and other specialty areas. Many of our clinical applications and workflow solutions can be added by OEMs as plug-ins to existing PACS workstations or used as dedicated, standalone workstations.

Merge Healthcare Product Portfolio

The breadth and depth of our products across Merge Healthcare reflects our core strategy of blending technologies, features and functions, modules and product lines to form medical imaging and information workflow solutions that are distributed globally and across three distribution channels: OEM and International, Direct and eCommerce. Our comprehensive product portfolio consists of the following:

FUSION RIS allows users to realize improvements in productivity by integrating information and automating traditional manual or paper methods related to scheduling, patient registration and tracking, document management, dictation, report turnaround, billing, claims processing and other mission critical operational functions in a medical imaging practice. This automation reduces administrative workload while increasing patient, referring physician and employee satisfaction. Additionally, the user can uncover ways to reduce bottlenecks, maximize profits and increase revenue through practice analysis tools.

FUSION MATRIX PACS is an image visualization, image management, archive and web distribution system. The workflow engine for radiologists, FUSION MATRIX PACS provides relevant clinical information at the radiologist s fingertips, and provides efficient distributed workflow that allows them to work at any location without sacrificing performance, workflow or feature functionality. The first PACS solution built on Microsoft.NET, its Smart Client technology, combines the power of the personal computer with the reach of the web for easier deployment, maintenance and improved local client performance.

FUSION PACS is an integrated repository of healthcare information and a suite of software application modules that provide PACS and web distribution of images and reports on a single, integrated PACS platform. FUSION PACS is the foundation for the integrated software application modules that provides optimal functionality for our customers radiology workflow. FUSION PACS and its modules are designed to allow the user to customize the way images and information are delivered and viewed, supporting user-centric workflow.

FUSION RIS/PACS was created through our comprehensive integration approach, fusing our RIS workflow with our image visualization, distribution and storage technologies into a unified, intelligent, distributed business and clinical workflow solution that helps our customers accelerate their productivity while also providing a higher level of value and convenience. Radiologists, technologists and administrators benefit from having a single solution for their mission critical business and clinical workflow tools, all integrated into a simpler, faster, unified desktop.

Referring Practice Portal allows real-time access to reports and their associated images from within FUSION RIS/PACS or just reports from FUSION RIS via the web. Additionally, the portal provides access to the Exam/Appointment Status, as well as offering an Emergency/Referral Access for hospital and clinic referrals in emergency situations. The portal has Health Insurance Portability and Accountability Act of 1996 (HIPAA) supportive security and auditing features, and can be customized with a facility s brand identity and service information. The referring practice portal is an optional module that can be purchased with FUSION RIS/PACS or FUSION RIS .

*Connectivity Tools support DICOM and HL7 interfacing while providing ready-made solutions for tackling various aspects of the hospital wide information workflow. Our connectivity tools include, but are not limited to, MergePort , MergeCOM3 , ExamWorks , MergeMVP , Cedara I-Acquire/FD , Cedara I-Bridge and DataBridge .

***eFilm Workstation** is a desktop diagnostic, image and analysis tool for viewing and interpreting medical images. eFilm Workstation is sold as stand alone software that allows radiologists to view and manipulate any digital diagnostic study, and is integrated into FUSION RIS/PACS and FUSION PACS as its diagnostic workstation. eFilm Workstation , sold via eCommerce from our website and through VAR distributors, is the most widely used diagnostic workstation in the world.

***Cedara I-ReadMammo** is a universal breast imaging workstation designed for reading mammography, ultrasound and MRI studies. Cedara I-ReadMammo eliminates the hassle of switching between different workstations through vendor independence, multi-modality support and dedicated tools for breast imaging workflow.

***Cedara B-CAD** is the world s first CAD solution designed to assist radiologists in analyzing breast ultrasound. With integrated tools for ACR BI- RADS® characterization and automatic report generation, Cedara B-CAD is an ideal complement for diagnostic breast ultrasound. Integrated with Cedara I-ReadMammo , Cedara B-CAD demonstrates functional multi-modality breast imaging workflow.

***Cedara PET/CT** provides fast and efficient workflow by combining images from CT and PET modalities, which is particularly useful in allowing a radiologist to see cancerous activity at a metabolic level and pinpoint its exact location in the tissue so a biopsy can be performed and proper treatment begun.

***Cedara OrthoWorks Planner** is a diagnostic workstation for orthopaedic surgical planning, templating, archiving and web distribution. OrthoWorks includes libraries of digital orthopaedic templates from all major prosthesis vendors, delivering advanced diagnostic and planning functionality for joint arthroplasty, trauma, deformity corrections and more.

Cedara OrthoWorks Spine Analyzer is an advanced application that helps spine surgeons, orthopedists, and chiropractors analyze cervical, thoracic and lumbar spine mobility, alignment and deformities. Spine surgeons can use OrthoWorks Spine Analyzer to assist in planning therapy, such as surgical procedures, and help evaluate post therapy outcome.

Cedara OrthoWorks Care Manager is a clinical data management system that uses unique patented technology to help easily capture relevant clinical parameters during diagnosis, therapy and post therapy follow up, and automatically populate an SQL database. Powerful and intuitive data mining tools allow users to quickly perform outcome analyses that can be later analyzed by a statistical package.

***CalScore Review** is an advanced calcium scoring module. It supports lesion-by-lesion and side-by-side comparison for follow up or repeat scanning, as well as detailed report generation. This clinical application also has workflow tools that allow customization of a patient database, tracking of the current referral base, comparison of prior versus current calcium scores and capture of follow-up appointments.

***Colon Review** is a complete workflow solution with powerful tools for reviewing colon or other luminal studies and reporting the findings. Colon Review is a practical, intuitive solution for expanding imaging capabilities to include virtual colonoscopy.

***Lung Review** is a comprehensive lung nodule visualization and analysis package that incorporates advanced viewing tools, nodule segmentation, decision tree based on ELCAP recommendations and automatic report generation.

***3D/4D Review** provides comprehensive visualization for rapid and efficient everyday clinical workflow, along with a real time editing tool one can use in combination with standard visualization tools such as MIP, MinIP, MPR, 3D, VRT and interactive 4D Image Review. This product is sold to the end-user market via eCommerce from our website, and through VAR distributors.

***AccuStitch** is an advanced image stitching and angle measurement application, which allows the user to stitch thoracic and lumbar films. This product is sold to the end-user market via eCommerce from our website, and through VAR distributors.

Cedara OpenEyes & Cedara BluePrint are advanced software platforms for the rapid development of medical imaging applications. Cedara OpenEyes provides a structured framework on which layered and protocol based applications can be quickly and efficiently created without reinventing

base functionality. Packaged with sophisticated image viewing, DICOM, databasing and image manipulation capabilities, Cedara OpenEyes allows healthcare companies to focus on the development of workflow and specific clinical tools. OpenEyes provides an excellent framework for both plug-in integration and complete software development. For additional development capabilities, Cedara BluePrint provides extended structure and features for the Cedara OpenEyes development environment.

Cedara I-SoftView is a family of clinically reliable, workflow-oriented PACS workstations.

Cedara I-Report is a radiologist s diagnostic workstation utilizing automated workflow, presentation protocols, and advanced post-processing toolsets.

Cedara I-Report CT is specifically tailored for CT data sets; this software features optimized navigation tools, easy-to-use 3D volume rendering, MPR, measurement tools, support for orthopedic templates, and Cedara Software s latest plug-ins.

Cedara I-Read is optimized for multi-modality viewing; the user preferences and intuitive user interfaces enable reporting physicians and specialists to have efficient, effective workflow.

Cedara I-View is a simple, cost-effective review station that provides DICOM connectivity with high performance display and facilitates clinicians access to patient data.

Cedara I-Acquire is a universal software application in which multiple digital detectors, computed radiography (CR) scanners and x-ray generators can be integrated into a powerful acquisition console, which improves ease of use and productivity for busy technologists, as well as giving OEMs and system integrators the freedom to choose and quickly package detectors, scanners, and generators from different vendors into an assortment of tailored solutions, thereby addressing a broader range of clinical applications with less effort and faster time to market.

***Cedara Baby Explorer** software is an application that adds 3D fetal imaging to any existing ultrasound system, allowing expectant parents, during scheduled ultrasound examinations, to view and record 3D images months before a baby s arrival. This product is sold to the end-user market via eCommerce from our website, and through VAR distributors.

***Cedara I-Reach** is a PACS web-based viewer that significantly advances the current capabilities of PACS viewers by providing fast access to images through the use of the latest compression techniques, while maintaining high image quality and providing complete seamless integration with hospital PACS, HIS and RIS.

***Cedara I-Store** is a DICOM compliant, scalable, archiving solution designed to meet the evolving performance and redundancy requirements of a healthcare enterprise. Its scalable architecture allows users to start small and expand the archive as their imaging requirements grow.

***Cedara** I-Conference assists healthcare professionals as a means to quickly and easily consolidate images and data for medical presentations, activities that normally represent a tedious and time consuming process. This allows presenters to focus on content development rather than formatting and technical issues. This product is sold to the end-user market via eCommerce from our website, and through VAR distributors.

***ExamWorks and ExamWorks+** are connectivity technologies that expand a modality s DICOM capabilities by providing efficient and transparent integration with departmental workflow and allow non-DICOM imaging devices to connect to a DICOM clinical network. They provide efficient and transparent network connectivity, allowing imaging devices to share resources throughout the department.

Cedara I-Response is a software solution for early detection of treatment response in brain cancer care that capitalizes on

a molecular imaging technique to assess tumor response from cellular mechanisms.

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Using functional diffusion mapping (DM), it provides the potential to evaluate the impact of anti-cancer drugs and radiation therapy on tumors at an unprecedented rate.

Cedara DentalWorks Implant Planner is an innovative dental implant planning system used by dentists and radiologists that makes the accurate planning and placement of dental implants easy. Using CT data and a smart, automated workflow, users can determine the optimal location of dental implants.

***Cedara aXigate** is an electronic patient record application that scales to provide enterprise-wide patient information-based workflow. This application has been implemented at a number of medical facilities as an Electronic Health Record (EHR), Healthcare Information Technology (HIT) and Clinical Information System (CIS).

* Indicates products sold to Direct and OEM customers.

Employees

We had approximately 550 employees as of December 31, 2005. In 2005, we implemented initiatives to enhance the work experiences and benefits that employees identified as being most important to them. With recognition that our employees are our most important assets, we will continue to invest in human capital development to ensure that we maintain our reputation as a highly desirable employer within our industry. See Recent Challenges above.

Sales, Marketing and Distribution

We use a multi-channel approach to reach our target customers. We struggled to realize synergistic benefits as a consequence of organizational changes, primarily within our sales and service groups, following our June 1, 2005 business combination with Cedara Software Corp. Nevertheless, we began introducing OEM clinical applications to the end-user healthcare market and to our RIS, PACS and RIS/PACS customers. We also cross sold RIS and PACS solutions to existing customers. We have added sales professionals to our sales force, and refined our sales processes and tracking mechanisms to provide real time information to manage our sales efforts. Of our net sales in the 12 months ended December 31, 2005, approximately 16% and 10% were attributable to sales to Toshiba Medical Systems Corporation and Hitachi Medical Corporation, respectively.

We have reached thousands of current and prospective customers through proactive electronic marketing, utilizing the emails and addresses captured in connection with eFilm Workstation downloads that numbered approximately 70,000 from July 2000 through July 2006. In addition, we regularly participate in major radiology and healthcare information system industry trade shows. The largest trade show, the RSNA 2005, which was held in Chicago, Illinois in November 2005, was a highly visible event for our product offerings and demonstrating our value propositions for our OEM and end-user customers. Finally, our ongoing participation in the IHE initiative and radiology industry panels regarding open communications and medical standards, including our Director of Quality and Medical Standards who served as the 2005 co-chair of the International DICOM committee through December 31, 2005, is an added opportunity to maintain a leadership position within the healthcare industry and enables us to demonstrate our value on many levels.

As a result of our business combination with Cedara Software Corp., we are able to capitalize on opportunities within our existing OEM customer base by offering an expanded portfolio of medical imaging technologies, development platforms and products. These opportunities aligned with our goal of cross selling our expanding product portfolio through all three distribution channels and will continue to be a core value for us in future years.

Competition

The markets for our products in the end-user market are highly competitive. Although the market for our OEM products may not appear to have as many third party competitors, we will often compete with an OEM s internal software engineering group to develop next generation technologies, or single product focused companies. Competition is present from new competitors entering the market, as well as current OEM partners that can offer products similar to our solutions.

In the developing area of RIS and PACS workflow applications, there are many newly emerging competitors that offer portions of the integrated radiology solution through their RIS and PACS to the market targeted by us. Additionally, certain competitors are integrating RIS and PACS technologies through development, partnership and acquisition activities.

We rely on our extensive experience in working in all aspects of the diagnostic imaging industry, our growing customer base, and our strong customer relations to maintain and grow our market share. We also rely on our global brand and historical installation base as a market leader in integration expertise. Our growing base of customers is increasingly demanding a single vendor that can provide RIS, PACS and clinical applications. In 2005, with the addition of Cedara and AccuImage, we became one of the few radiology software vendors that can offer such comprehensive workflow solutions across many clinical specialties that utilize medical imaging.

Many of the current and potential competitors may have greater resources than we have, including greater financial resources, research and development capabilities, intellectual property and marketing resources. Many of these competitors may also have broader product lines and longer standing relationships with customers. Our ability to compete successfully depends on a number of factors both in and outside of our control, including: product innovation; product quality and performance; price; experienced sales, marketing and service professionals; rapid development of new products and features; and product and policy decisions announced by competitors. There can be no assurance that we will be able to compete successfully.

Intellectual Property Rights

We currently own 21 patents issued by the intellectual property offices of various jurisdictions, including the U.S. Patent and Trademark Office (PTO) and the Canadian Intellectual Property Office (CIPO). We continue to expand our intellectual property portfolio and have applied for 29 additional patents currently under review by the PTO, CIPO or Korean Intellectual Property Office. There can be no assurance that these patents will afford any commercial benefits. We do not, however, rely principally on patent protection with respect to our products. We also rely on a combination of copyright and trade secret laws, employee and third party confidentiality agreements and other measures to protect intellectual property rights pertaining to our systems and technology. We currently hold 35 registered or unregistered trademarks in the United States or Canada, and have applied for at least two trademarks currently under review by the PTO or CIPO. Our trademarks include FUSION RIS , FUSION MATRIX PACS , FUSION PACS , FUSION RIS/PACS , Referring Practice Portal , eFilm Workstation , Cedara I-ReadMammo , Cedara B-CAD , Cedara PET/CT , Cedara PET/CT , Cedara OrthoWorks Planner , Cedara OrthoWorks Spine Analyzer , Cedara OrthoWorks Care Manager , CalScore Review , Colon Review , Lung Review , 3D/4D Review , AccuStitch , Cedara OpenEyes , Cedara BluePrint , Cedara I-SoftVie Cedara I-Report , Cedara I-Report CT , Cedara I-Read , Cedara I-View , Cedara I-Acquire , I-Route , Cedara I-Reach , Cedara I-Store , Cedara I-Conference , ExamWorks , ExamWorks+ , Cedara I-Response and Cedara DentalWorks Implant Planner . We believe that, in the age of rapidly changing technology, our continued success is primarily dependent upon the technical competence and creative skill of our personnel, in addition to our patents, copyrights and other proprietary rights.

Medical, Regulatory and Government Standards and Reforms

The healthcare industry is subject to changing political, economic and regulatory influences that may affect the procurement practices and operation of the entire healthcare industry. Proposals to reform the U. S. healthcare system have been, and will continue to be, considered by Congress. We believe we have positioned ourselves to assist our customers in the utilization, implementation, and adherence to most major radiology standards and regulations. We cannot, however, predict with any certainty what impact, if any, new proposals, healthcare reforms or standards might have on the business, our financial condition and our results of operations. See Part I, Item 1A, Risk Factors to this Annual Report on Form 10-K for a description of various industry and regulatory risks.

The following are examples of some of the issues, standards and regulations that we monitor and prepare ourselves to address to protect our enterprise and that of our customers:

- Changes in Medicare and private insurance reimbursement rates may affect the financial health of our customers businesses. For example, on February 8, 2006, the President signed into law the Deficit Reduction Act of 2005 (DRA). Effective for services provided on or after January 1, 2007, the DRA provides that reimbursement for the technical component for imaging services (excluding diagnostic and screening mammography) in non-hospital based freestanding facilities will be capped at the lesser of reimbursement under the Medicare Part B physician fee schedule or the Hospital Outpatient Prospective Payment System (HOPPS) schedule. See Part I, Item 1A, Risk Factors for a discussion of the risks and effects of the DRA.

- The Health Insurance Portability and Accountability Act of 1996 (HIPAA) has mandated the use of standard transactions and identifiers, prescribed security measures and other provisions designed to simplify and secure the exchange of medical information. The compliance dates for initial phases of the requirements phase began on April 14, 2003, and continued through 2005. We took necessary measures to assist our customers to meet HIPAA compliance.

- The U.S. Food and Drug Administration (FDA), which is responsible for assuring the safety and effectiveness of medical devices under the Federal Food, Drug and Cosmetic Act, has regulatory jurisdiction over computer software applications when they are labeled or intended to be used in the diagnosis of disease or other conditions. In Canada, medical devices are regulated under Health Canada s Medical Devices Regulations (Health Canada). Our ability to market new products and improvements to existing products depends upon the timing of appropriate licenses, pre-market clearance or approval from the FDA, Health Canada, or other applicable foreign regulatory authorities. Failure to comply with applicable domestic or other foreign regulatory requirements at any time during the production, marketing or distribution of products regulated by the FDA, Health Canada or other applicable foreign regulatory authorities could result in, among other things, seizures of products, total or partial suspension of production, refusal to grant licenses, clearances or approvals, withdrawal of existing licenses, clearances or approvals, or criminal prosecution, any one of which could have a material adverse effect on our business, financial condition, results of operations and prospects.

- International sales of products outside of the U. S. are subject to foreign regulatory requirements (in particular, the requirements of the European Union, where most of our international sales are made), that can vary from country to country.

- Laws and regulations may be adopted to address Internet commerce such as online content, user privacy, pricing and characteristics and quality of applications and services.

- The tax treatment of the Internet and eCommerce is currently unsettled.

We continue to allocate internal resources to industry standards committees and working groups who are tasked with setting and promoting both technology and functionality standards within the diagnostic imaging and healthcare information systems markets. Participating in IHE and a variety of DICOM working groups specializing in HIPAA, HL7 and other standards helps to ensure that our products and services align with the efforts of these committees and meet the evolving interoperability needs of healthcare technologies.

Other Information

Our website address is www.merge.com. We make available within the Investors Relations portion of our website under the caption SEC Filings, free of charge, our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, including any amendments to those reports, as soon as reasonably practicable after we electronically file them with, or furnish them to, the SEC. Materials we file with or furnish to the SEC may also be read and copied at the SEC s Public Reference Room at 100 F Street, NE, Room 1580, Washington, D.C. 20549. Information on the operation of the Public Reference Room may be obtained by calling the SEC at 1-800-SEC-0330. Also, the SEC maintains an Internet site at www.sec.gov that contains reports, proxy and information statements, and other information that we file electronically with SEC.

Item 1A. RISK FACTORS

You should carefully consider the risks, uncertainties and other factors described below, in addition to the other information set forth in this Annual Report on Form 10-K, because they could materially and adversely affect our business, operating results, financial condition, cash flows and prospects, as well as adversely affect the value of an investment in our Common Stock. Also, you should be aware that the risks and uncertainties described below are not the only ones facing us. Additional risks and uncertainties that we do not yet know of, or that we currently think are immaterial, may also impair our business operations. You should also refer to the other information contained in and incorporated by reference into this Annual Report on Form 10-K, including our consolidated financial statements and the related notes.

We have identified material weaknesses in our disclosure controls and procedures and our internal control over financial reporting, which, if not remedied effectively, could have an adverse effect on the trading price of our Common Stock and otherwise seriously harm our business As discussed in Item 9A, Controls and Procedures in Part II of this Annual Report on Form 10-K, from January 10, 2006 to May 26, 2006, we received 11 anonymous letters primarily alleging improprieties relating to our financial reporting, fulfillment of customer contracts and disclosure practices. More specifically, the letters contained allegations of improper revenue recognition practices. The Audit Committee 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. Based upon the normal year end closing process and the preliminary findings of the investigation, w