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MERGE TECHNOLOGIES INC  
Form 10-Q  
November 08, 2004

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D. C. 20549  
FORM 10-Q

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

For the quarterly period ended September 30, 2004

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 (IRS Employer Identification No.)  
of incorporation or organization)

1126 South 70th Street, Milwaukee, WI 53214-3151  
(Address of principal executive offices)

(414) 977-4000  
(Issuer's telephone number)

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 X No  
-----

Indicate by check mark whether the Registrant is an accelerated filer  
(as defined in Rule 12b-2 of the Exchange Act). Yes X No  
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As of November 4, 2004, the Registrant had 13,163,750 shares of Common Stock  
outstanding.

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### PART I

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#### ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS

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#### MERGE TECHNOLOGIES INCORPORATED AND SUBSIDIARIES CONSOLIDATED BALANCE SHEETS (in thousands, except for share data)

	September 30, 2004	December 2003
	-----	-----
	(Unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents.....	\$ 23,977	\$ 16,8
Accounts receivable, net of allowance for doubtful accounts of \$404 and \$374 at September 30, 2004 and December 31, 2003, respectively.....	10,254	8,3
Inventory.....	1,094	8
Prepaid expenses.....	606	2
Deferred tax asset.....	2,620	3,5
Other current assets.....	1,124	1
	-----	-----

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Total current assets.....	39,675	30,1
Property and equipment:		
Computer equipment.....	5,021	4,8
Office equipment.....	745	7
Leasehold improvements.....	347	2
	6,113	5,7
Less accumulated depreciation and amortization.....	4,689	4,1
Net property and equipment.....	1,424	1,6
Long-term accounts receivable.....	78	1
Purchased and developed software, net of accumulated amortization of \$9,030 and \$7,314 at September 30, 2004 and December 31, 2003, respectively.....	9,502	8,4
Intangibles - customer contracts, net of accumulated amortization of \$663 and \$371 at September 30, 2004 and December 31, 2003, respectively.....	1,280	1,5
Goodwill.....	21,714	21,8
Other.....	51	1
Total assets.....	\$ 73,724	\$ 63,8

LIABILITIES AND SHAREHOLDERS' EQUITY

Current liabilities:		
Accounts payable.....	\$ 1,346	\$ 1,2
Accrued wages.....	1,338	9
Notes payable.....	----	2
Redemption value related to exchangeable Common Stock.....	----	
Other accrued liabilities.....	786	7
Deferred revenue.....	5,426	3,7
Billings in excess of revenues - contracts in progress.....	2,333	1,3
Total current liabilities.....	11,229	8,3
Deferred tax liability.....	2,170	1,9
Total liabilities.....	13,399	10,3
Shareholders' equity:		
Preferred stock, \$0.01 par value: 3,999,998 shares authorized; zero shares issued and outstanding at September 30, 2004 and December 31, 2003.....	\$ ----	\$ --
Series A Preferred Stock, \$0.01 par value: 1,000,000 shares authorized; zero shares issued and outstanding at September 30, 2004 and December 31, 2003.....	----	--
Special Voting Preferred stock, no par value: one share authorized; zero shares and one share issued and outstanding at September 30, 2004 and December 31, 2003, respectively.....	----	--
Series 2 Special Voting Preferred stock, no par value: one share authorized; zero shares and one share issued and outstanding at September 30, 2004 and December 31, 2003, respectively.....	----	--
Common Stock, \$0.01 par value: 30,000,000 shares authorized; 13,122,553 shares and 12,485,646 shares issued and outstanding at September 30, 2004 and December 31, 2003, respectively.....	131	1
Common Stock subscribed: 1,187 and 8,058 shares at September 30, 2004 and December 31, 2003, respectively.....	17	
Additional paid-in capital.....	54,740	53,1

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Retained earnings (accumulated deficit).....	5,032	(
Accumulated other comprehensive income - cumulative translation adjustment.....	405	2
Total shareholders' equity.....	60,325	53,5
Total liabilities and shareholders' equity.....	\$ 73,724	\$ 63,8

See accompanying notes to consolidated financial statements.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Net sales.....	\$ 9,307	\$ 7,619	\$ 26,851	\$ 20,1
Cost of sales.....	3,208	2,586	9,599	6,2
Gross profit.....	6,099	5,033	17,252	13,9
Operating costs and expenses:				
Sales and marketing.....	1,683	1,669	5,088	4,4
Product research and development.....	559	566	1,464	1,4
General and administrative.....	1,258	901	3,194	2,4
Depreciation and amortization.....	202	159	587	3
Total operating costs and expenses.....	3,702	3,295	10,333	8,7
Operating income.....	2,397	1,738	6,919	5,1
Other income (expense):				
Interest expense.....	(3)	(4)	(13)	(
Interest income.....	80	35	183	
Other, net.....	15	66	82	(1
Total other income (expense).....	92	97	252	(1
Income before income taxes.....	2,489	1,835	7,171	5,0
Income tax expense.....	252	210	2,083	6
Net income.....	\$ 2,237	\$ 1,625	\$ 5,088	\$ 4,3
Net income per share - basic.....	\$ 0.17	\$ 0.13	\$ 0.39	\$ 0.
Weighted average number of common				

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shares outstanding - basic.....	13,039,123	12,233,517	12,964,960	11,158,8
	=====	=====	=====	=====
Net income per share - diluted.....	\$ 0.16	\$ 0.12	\$ 0.37	\$ 0.
	=====	=====	=====	=====
Weighted average number of common shares outstanding - diluted.....	13,748,894	13,333,497	13,773,599	12,155,3
	=====	=====	=====	=====

See accompanying notes to consolidated financial statements.

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

	Nine Months Ended September 30,	
	2004	2003
	-----	-----
Cash flows from operating activities:		
Net income.....	\$ 5,088	\$ 4,342
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization.....	2,620	1,803
Amortization of discount on note acquired in merger.....	11	11
Provision for doubtful accounts receivable.....	30	71
Deferred income taxes.....	1,176	----
Change in assets and liabilities, net of effects of acquisitions:		
Accounts receivable.....	(1,914)	1,111
Inventory.....	(201)	(240)
Prepaid expenses.....	(315)	(125)
Accounts payable.....	104	(797)
Accrued wages.....	424	(43)
Other accrued expenses.....	379	836
Deferred revenue and billings in excess of revenues.....	2,658	1,087
Other.....	(807)	(12)
	-----	-----
Net cash provided by operating activities.....	9,253	8,044
	-----	-----
Cash flows from investing activities:		
Acquisitions, net of cash acquired.....	----	(4,416)
Purchases of property and equipment.....	(328)	(814)
Capitalized software development.....	(2,672)	(1,902)
	-----	-----
Net cash used in investing activities.....	(3,000)	(7,132)
	-----	-----
Cash flows from financing activities:		
Proceeds from notes receivable from related party.....	----	25
Proceeds from sale of Common Stock.....	----	7,745
Proceeds from exercise of stock options and warrants.....	1,042	1,897
Proceeds from employee stock purchase plan.....	54	106

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Repayment of note payable.....	(227)	----	----
Principal payments under capital leases.....	----	-----	(7)
Net cash provided by financing activities.....	869	-----	9,766
Effect of exchange rate changes on cash.....	(16)	-----	149
Net increase in cash and cash equivalents.....	7,106	-----	10,827
Cash and cash equivalents, beginning of period.....	16,871	-----	4,411
Cash and cash equivalents, end of period.....	\$ 23,977	=====	\$ 15,238
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:			
Cash paid for income taxes.....	\$ 1,188	-----	\$ 174
Cash paid for interest.....	----	-----	1
NON-CASH FINANCING AND INVESTING ACTIVITIES:			
Common Stock and options issued for acquisitions.....	----	-----	12,493
Redemption value related to exchangeable Common Stock.....	1	-----	39

See accompanying notes to consolidated financial statements.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Net income.....	\$ 2,237	\$ 1,625	\$ 5,088	\$ 4,3
Accumulated other comprehensive income - Cumulative translation adjustment..	188	28	173	2
Comprehensive net income.....	\$ 2,425	\$ 1,653	\$ 5,261	\$ 4,6

See accompanying notes to consolidated financial statements.

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 accounting

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principles generally accepted in the United States of America 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 doing business as Merge eFilm, and its subsidiaries and affiliates ("we," "us" or "our").

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.

### Stock-Based Compensation

-----

We maintain three stock-based employee compensation plans and one director option plan. We apply the provisions of Statement of Financial Accounting Standards ("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 Opinion No. 25 ("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 would have been decreased in the three and nine months ended September 30, 2004 and 2003, to the pro forma amounts indicated below:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
	-----	-----	-----	-----
Net income, as reported.....	\$ 2,237	\$ 1,625	\$ 5,088	\$ 4,3
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax benefits.....	(462)	(296)	(869)	(6
Pro forma net income.....	\$ 1,775	\$ 1,329	\$ 4,219	\$ 3,6
	=====	=====	=====	=====
Earnings per share:				
Basic - as reported.....	\$ 0.17	\$ 0.13	\$ 0.39	\$ 0.
	=====	=====	=====	=====
Basic - pro forma.....	\$ 0.14	\$ 0.11	\$ 0.33	\$ 0.
	=====	=====	=====	=====
Diluted - as reported.....	\$ 0.16	\$ 0.12	\$ 0.37	\$ 0.
	=====	=====	=====	=====
Diluted - pro forma.....	\$ 0.13	\$ 0.10	\$ 0.31	\$ 0.

=====

Guarantees

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In November 2002, the Financial Accounting Standards Board (FASB) issued Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others ("FIN 45"). FIN 45

MERGE TECHNOLOGIES INCORPORATED AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited and in thousands, except for share data)

requires that we recognize the fair value for guarantee and indemnification arrangements issued or modified by us after December 31, 2002, if these arrangements are within the scope of the interpretation. In addition, we must continue to monitor the conditions that are subject to the guarantees and indemnifications, as required under the previously existing generally accepted accounting principles, in order to identify if a loss has occurred. If we determine it is probable that a loss has occurred, then any such estimable loss would be recognized under those guarantees and indemnifications. Under our standard Software License, Services and Maintenance Agreement, we agree to indemnify, defend and hold harmless our licensees from and against certain losses, damages and costs arising from claims alleging the licensees' use of our software infringes the intellectual property rights of a third party. Historically, we have not been required to pay material amounts in connection with claims asserted under these provisions and, accordingly, we have not recorded a liability relating to such provisions. Under our standard Software License, Services and Maintenance Agreement, we also represent and warrant to licensees that our software products operate substantially in accordance with published specifications, and that the services we perform will be undertaken by qualified personnel in a professional manner conforming to generally accepted industry standards and practices. Historically, only minimal costs have been incurred relating to the satisfaction of product warranty claims and, as such, no accrual for warranty claims has been made. Other guarantees include promises to indemnify, defend and hold harmless each of our executive officers, non-employee directors and certain key employees from and against losses, damages and costs incurred by each such individual in administrative, legal or investigative proceedings arising from alleged wrongdoing by the individual while acting in good faith within the scope of his or her job duties on our behalf. Historically, minimal costs have been incurred relating to such indemnifications and, as such, no accrual for these guarantees have been made.

(2) GOODWILL AND OTHER INTANGIBLES

Goodwill is our only unamortizable intangible asset. In the nine months ended September 30, 2004, we reduced goodwill by \$132 due to the refund of Canadian tax credits associated with software development efforts related to periods prior to our acquisition of eFilm Medical Inc. ("eFilm"). The changes in the carrying amount of goodwill in the nine months ended September 30, 2004, are as follows:



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Balance as of January 1, 2004.....	\$ 21,846
Goodwill related to eFilm acquisition.....	(132)
	-----
Balance as of September 30, 2004.....	\$ 21,714
	=====

Our intangible assets, other than internally developed software, subject to amortization are summarized as of September 30, 2004, as follows:

	Weighted Average Remaining Amortization Period (Years)	Gross Carrying Amount	Accumulated Amortization
	-----	-----	-----
Purchased software.....	3.1	\$ 2,901	\$ (1,089)
Customer contracts.....	3.3	1,943	(663)
		-----	-----
Total.....	3.2	\$ 4,844	\$ (1,752)
		=====	=====

MERGE TECHNOLOGIES INCORPORATED AND SUBSIDIARIES  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 (Unaudited and in thousands, except for share data)

Amortization expense was \$736 for the nine months ended September 30, 2004. Estimated aggregate amortization expense for each of the next five years is as follows:

For the remaining three months:	2004	\$ 238
For the year ended December 31:	2005	\$ 935
	2006	\$ 924
	2007	\$ 708
	2008	\$ 287

(3) INCOME PER SHARE

Basic earnings per share are computed by dividing income available to common shareholders by the weighted average number of common shares and share exchange rights outstanding if conversion is dilutive to the calculation. Diluted earnings per share reflects the potential dilution that could occur based on the exercise of stock options and warrants 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 nine months ended September 30, 2004 and 2003.

Three Months Ended September 30,		Nine Months Ended September 30,	
-----	-----	-----	-----
2004	2003	2004	2003
-----	-----	-----	-----

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Numerator:								
Net Income.....	\$	2,237	\$	1,625	\$	5,088	\$	4,3
Accretion of redemption value related to Interpra exchangeable shares.....		----		(6)		----		(
Allocation of income to Interpra exchangeable shares.....		----		(4)		(1)		(
		-----		-----		-----		-----
Numerator for net income per shares - basic and diluted.....	\$	2,237	\$	1,615	\$	5,087	\$	4,2
		=====		=====		=====		=====
Denominator:								
Weighted average number of shares of Common Stock and participating securities outstanding.....		13,039,123		12,233,517		12,964,960		11,158,8
		-----		-----		-----		-----
Effect of stock options.....		709,771		1,086,554		808,639		934,3
Effect of warrants.....		----		13,426		----		62,2
		-----		-----		-----		-----
Denominator for net income per share - diluted.....		13,748,894		13,333,497		13,773,599		12,155,3
		=====		=====		=====		=====
Net income per share - basic.....	\$	0.17	\$	0.13	\$	0.39	\$	0.
Net income per share - diluted.....	\$	0.16	\$	0.12	\$	0.37	\$	0.

For the three months ended September 30, 2004 and 2003, 434,375 options and zero options and warrants, respectively, to purchase shares of our Common Stock had exercise prices greater than the average market price of the shares of Common Stock.

For the nine months ended September 30, 2004 and 2003, 323,500 options and 155,000 options and warrants, respectively, to purchase shares of our Common Stock had exercise prices greater than the average market price of the shares of Common Stock.

(4) ACQUISITIONS

On July 17, 2003, we acquired all of the outstanding capital stock of RIS Logic, Inc. ("RIS Logic") pursuant to a Merger Agreement dated July 9, 2003, for a total purchase price of \$16,984 consisting primarily of cash, vested options and 771,804 shares of Common Stock. RIS Logic has been in the business of the development and sales of Radiology Information System ("RIS") products to end user imaging centers.

We paid a significant premium above the fair value of RIS Logic's tangible net assets principally because we determined that RIS Logic's software development ability and trade name are particularly important to us. As we

MERGE TECHNOLOGIES INCORPORATED AND SUBSIDIARIES  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 (Unaudited and in thousands, except for share data)

looked to the future, we foresaw the need to expand our software product

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offerings to healthcare institutions and imaging centers as many of our competitors are developing more integrated solutions. In addition, we are selling our software products to RIS Logic's customers. The fair value of each share issued to RIS Logic was determined to be \$14.305 using a four-day average of the closing price of our Common Stock before and after the signing of the definitive agreement.

An escrow of 173,093 shares of Common Stock was established as a reserve for 18 months, which will terminate on January 16, 2005, against any claims regarding breaches or representations and warranties.

The acquisition was accounted for using the purchase method of accounting. The accompanying consolidated statements of operations include the results of operations for RIS Logic since the acquisition date, July 17, 2003. The amount allocated to purchased and developed software is being amortized over a five-year period. The estimated asset life is determined based on projected future economic benefits and expected life cycles of the technologies. 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 RIS Logic:

Form of Consideration	Fair Value
Cash.....	\$ 4,311
771,804 shares of Common Stock.....	11,041
Vested stock options.....	1,452
Transaction costs.....	180
Total consideration.....	\$ 16,984

The total purchase consideration of approximately \$16,984 was allocated to the fair value of the net assets acquired as follows:

	Fair Value
Current assets.....	\$ 2,184
Other assets.....	247
Purchased and developed technologies.	1,483
Customer contracts.....	977
Goodwill.....	14,469
Liabilities assumed.....	(2,376)
Total consideration.....	\$ 16,984

The \$14,469 assigned to goodwill in the acquisition will not be deductible for federal income tax purposes.

### 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

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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 (the "Securities Act"), 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, our lack of consistent profitability, fluctuations in operating results, credit and payment risks associated with end-user sales, involvement with rapidly developing technology in highly competitive markets, acquisition and development of new technologies, dependence on major customers, expansion of our international sales effort, broad discretion of management and dependence on key personnel, risks associated with product liability and product defects, risks of loss associated with potential infringement of our products or services on the intellectual property rights of others, costs of complying with government regulation, changes in external competitive market factors which might impact trends in our results of operations, unanticipated working capital and other cash requirements, general changes in the industries in which we compete, 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 condensed consolidated financial statements and notes thereto appearing elsewhere in this report.

### Overview

-----

We started operations in 1987 and are a leading provider of Picture Archiving and Communications Systems ("PACS") and RIS software to imaging centers, specialty clinics, small and medium sized hospitals, and PACS component and connectivity technologies to many Original Equipment Manufacturers ("OEM's") throughout the world. We are an active leader in the development in the industry standard network communications protocol known as Digital Imaging Communications in Medicine ("DICOM") technology, which defines the standard configuration for digital imaging used in the medical and healthcare industry. DICOM is used by virtually all OEM's building modalities for healthcare.

Our products fuse business and clinical workflow by intelligently managing and distributing diagnostic images and information throughout the healthcare enterprise. 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, multi-hospital groups, and specialty clinics.

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. Within the United States of America, we are focusing our direct sales efforts

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on single and multi-site imaging centers with more than 10,000 studies per year, small to medium sized hospitals (less than 400 beds), and certain specialty clinics like orthopedic practices that offer imaging services. The Frost and Sullivan 2002 survey indicated that less than 30% of those markets are currently using a PACS to achieve a filmless workflow environment and an even smaller percentage has a fully integrated RIS/PACS delivering filmless and paperless workflow.

The markets for our products are highly competitive. Many customers purchase products both from us and from our competitors. Our historical connectivity solutions product line has been the mainstay, which pioneered our development. The competitive challenge is that similar products are readily available and the connectivity products are incorporated into most imaging modalities. 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 the market targeted by us. Additionally, certain competitors are integrating RIS and PACS technologies through development, partnership and acquisition activities. We rely on our global brand and historical installation base as the market leader in connectivity products and desktop software image viewing applications (eFilm Workstation(tm)). This installed base, reputation for clinical and technical quality and long-term service is a key differentiator among the competition. In addition, we believe our software modular technique to implementing a customized, fully integrated solution is appealing to our target market and is the foundation of our approach.

We have aggressively expanded our product offering, especially in the past two years, through our acquisitions of eFilm and RIS Logic. We became a full PACS provider in September 2002 through our acquisition of eFilm which provided the visualization platform, which when combined with our existing PACS components, allowed us to release our first integrated PACS system for the small and medium sized hospital and imaging center market. The eFilm Workstation(tm) also is core to our strategy to own the clinician desktop market. We sell our eFilm Workstation(tm) on the Internet for a small annual subscription. This strategy allows those radiologists or clinicians who are reluctant to move to reading images digitally, to do so easily and very 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 PACS deliver filmless workflow and a RIS deliver paperless workflow. We see these products as core elements behind our success in achieving our results in the three and nine months ended September 30, 2004, and for the foreseeable future.

### SIGNIFICANT EVENTS IN THE THREE MONTHS ENDED SEPTEMBER 30, 2004

During the three months ended September 30, 2004, we continued to focus on a core set of strategic and operational objectives designed to reinforce our market-leading position as a RIS/PACS solution provider and achieve our financial goals. We continue to see accelerating interest from our target market for a comprehensive workflow solution from a single, trusted healthcare software solutions provider. We have remained consistent in our focus on imaging centers, small to medium size hospitals, and specialty clinics, including a growing target market of orthopedic groups and neurosurgery

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centers.

During the three months ended September 30, 2004, we entered into 19 new FUSION(tm) contracts, growing our total number of FUSION(tm) RIS, PACS or RIS/PACS solution customers to 174, representing 366 healthcare facilities. In addition, we expanded our relationship with InSight Health to a total of 25 of their 118 fixed-site imaging center facilities and signed a new contract with Radiologix, Inc. for approximately 15 of their 94 imaging centers based in their Northeast Region.

Our OEM/value added resellers ("VARs") channel improved from the first two quarters of 2004. The accomplishments include increased FUSION(tm) PACS software modules and components sales to our European VARs along with timely implementations of these systems for their customers, improved OEM licensing among existing customers and continued development of our relationship with our largest OEM customer as additional versions of our Health Level Seven (HL7)/DICOM integration software product are released.

We continue our focus on customer-driven product innovation, including hosting our first annual user's group conference in October. We expect to present a number of new features, functions and product upgrades in the industry's largest trade show, Radiological Society of North America ("RSNA"), in late November. In addition, our product quality initiatives continue to

meet our expectations as evidenced by our successful annual International Standards Organization (ISO) audit completed during the three months ended September 30, 2004.

### RESULTS OF OPERATIONS

(in thousands)

Three Months Ended September 30, 2004 Compared to Three Months Ended September 30, 2003

The following table sets forth selected unaudited consolidated financial data for the periods indicated, expressed as a percentage of net sales.

	Three Months Ended September 30,	
	2004	2003
Net sales.....	100%	100%
Cost of sales.....	34	34
	-----	-----
Gross profit.....	66	66
	-----	-----
Operating costs and expenses:		
Sales and marketing.....	18	22
Product research and development.....	6	7
General and administrative.....	14	12
Depreciation and amortization.....	2	2
	-----	-----
Total operating costs and expenses.....	40	43

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Operating income.....	26	23
Total other income, net.....	1	1
Income before income taxes.....	27	24
Income tax expense.....	3	3
Net income.....	24%	21%

Net Sales

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Net sales consist of sales made directly to healthcare facilities, the professional services associated with those sales and sales made to OEM/VARs, net of estimated product returns. The following table sets forth net sales component data.

	Three Months Ended September 30,		% Change
	2004	2003	
Direct sales.....	\$ 3,366	\$ 2,085	61%
As a percentage of total net sales.....	36%	27%	
Professional services.....	\$ 3,027	\$ 2,376	27%
As a percentage of total net sales.....	33%	31%	
OEM/VARs.....	\$ 2,914	\$ 3,158	(8%)
As a percentage of total net sales.....	31%	42%	
Total net sales.....	\$ 9,307	\$ 7,619	22%

Direct sales consist of software and purchased components delivered in PACS, RIS and RIS/PACS sales to healthcare facilities and imaging centers. The \$1,281 increase in direct sales in the three months ended September 30, 2004 compared to the three months ended September 30, 2003 is attributed to revenue recognized on RIS, PACS and RIS/PACS deals.

Net sales from the professional services group increased \$651 in the three months ended September 30, 2004 compared to the three months ended September 30, 2003. The net sales growth from the professional services group is due to the growth in sales made directly to healthcare facilities and imaging centers, where such sales are accompanied by installation services and service contracts.

Net sales to OEM/VARs and dealers decreased \$244 in the three months ended September 30, 2004 attributed to the long-term OEM component business with one customer in reaching the end of its contractual life earlier in the year, while the new software product line released for this customer in the second quarter of 2004 has not yet reached sales levels equivalent to the

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long-term component business.

### Cost of Sales

-----

Cost of sales consists of purchased components and service costs associated with net sales, amortization of purchased and developed software and acquired customer contracts.

The cost of purchased components decreased to \$964 in the three months ended September 30, 2004 compared to \$1,061 in the three months ended September 30, 2003, as primarily a result of a shift in our OEM/VAR sales towards more software centric deals during the three months ended September 30, 2004.

The cost of professional services increased to \$1,490 in the three months ended September 30, 2004 compared to \$1,014 in the three months ended September 30, 2003. The increase is due to the growing number of RIS, PACS and RIS/PACS sales in 2004 and required headcount growth to install and maintain ongoing service and support for direct sales customers.

Amortization of purchased and developed software increased to \$754 in the three months ended September 30, 2004 compared to \$511 in the three months ended September 30, 2003. As a percentage of net sales, amortization of purchased and developed software increased slightly to 8% in the three months ended September 30, 2004 compared to 7% in the three months ended September 30, 2003. The dollar increase in the three months ended September 30, 2004 is a result of the commencement of amortization on software available for general release.

### Gross Profit

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Gross profit increased 21% to \$6,099 in the three months ended September 30, 2004 from \$5,033 in the three months ended September 30, 2003. As a percentage of net sales, gross profit remained flat at 66% of net sales in the three months ended September 30, 2004 compared to the three months ended September 30, 2003.

### Sales and Marketing

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Sales and marketing expense increased to \$1,683 in the three months ended September 30, 2004 from \$1,669 in the three months ended September 30, 2003. The slight increase is the result of our objective to invest in sales and marketing activities, particularly for sales team efforts in connection with sales made directly to healthcare facilities and imaging centers.

### Product Research and Development

-----

Research and development expense as a percentage of net sales remained relatively consistent at 6% for the three months ended September 30, 2004 compared to 7% for the three months ended September 30, 2003. Research and development expense also remained relatively consistent at \$559 in the three months ended September 30, 2004 compared to \$566 in the three months ended September 30, 2003. Capitalization of software development costs increased \$51 to \$799 in the three months ended September 30, 2004, from \$748 in the three months ended September 30, 2003, as a result of our developing FUSION(tm) application modules and further integration of our RIS/PACS technologies.



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### General and Administrative

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General and administrative expense as a percentage of net sales increased to 14% for the three months ended September 30, 2004 compared to 12% for the three months ended September 30, 2003. General and administrative expense increased 40% to \$1,258 in the three months ended September 30, 2004 from \$901 in the three months ended September 30, 2003. General and administrative expense includes costs for information systems, accounting, administrative support, management personnel, bad debt expenses and general corporate matters. The \$357 increase is primarily attributed to increased costs associated with corporate compensation and compliance with the Sarbanes - Oxley Act of 2002.

### Depreciation and Amortization

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Depreciation and amortization expense as a percentage of net sales remained constant at 2% for the three months ended September 30, 2004 and September 30, 2003. Depreciation and amortization expense increased 27% to \$202 in the three months ended September 30, 2004 from \$159 in the three months ended September 30, 2003. Depreciation and amortization is assessed on capital equipment and intangible assets with estimable useful lives. This excludes the amortization of capitalized software, which is a component of cost of sales.

### Other Income, Expense

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Our interest expense remained relatively consistent at \$3 in the three months ended September 30, 2004 compared to \$4 in the three months ended September 30, 2003, while interest income was \$80 in the three months ended September 30, 2004 compared to \$35 in the three months ended September 30, 2003. The increase in interest income is directly attributed to our increased cash and cash equivalents balance at September 30, 2004 and the increase in interest rates. Other income, net, was \$15 in the three months ended September 30, 2004 compared to \$66 in the three months ended September 30, 2003. The other income, net, in the three months ended September 30, 2003 is attributed to a decrease in prior unrealized foreign exchange losses on United States dollar receivables and cash held in our Canadian subsidiary, where the functional currency is the Canadian dollar.

### Income Taxes

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We recorded income tax expense of \$252 in the three months ended September 30, 2004 and \$210 in the three months ended September 30, 2003. Our estimated domestic and international effective tax rate for 2004 is 29%, compared to the estimated 2003 effective tax rate of approximately 14%. The 2004 effective tax rate was reduced in the three months ended September 30, 2004, as compared to the effective tax rate of 39% for the six months ended June 30, 2004, by our ability to exclude from United States taxation a portion of the profits associated with the international sales of our software products. The 2003 effective tax rate was benefited by the reduction of valuation allowances associated with net operating loss and tax credit carryforwards.

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Nine Months Ended September 30, 2004 Compared to Nine Months Ended  
September 30, 2003

The following table sets forth selected unaudited consolidated financial data for the periods indicated, expressed as a percentage of net sales.

	Nine Months Ended September 30,	
	2004	2003
Net sales.....	100%	100%
Cost of sales.....	36	31
Gross profit.....	64	69
Operating costs and expenses:		
Sales and marketing.....	19	22
Product research and development.....	5	7
General and administrative.....	12	12
Depreciation and amortization.....	2	2
Total operating costs and expenses.....	38	43
Operating income.....	26	26
Total other income (expense), net.....	1	(1)
Income before income taxes.....	27	25
Income tax expense.....	8	3
Net income.....	19%	22%

### Net Sales

Net sales consist of sales made directly to healthcare facilities, the professional services associated with those sales and sales made to OEM/VARS, net of estimated product returns. Net sales for the nine months ended September 30, 2004 include the results of our acquisition of RIS Logic on July 17, 2003, while net sales for the nine months ended September 30, 2003 include only activity since the acquisition date. The following table sets forth net sales component data.

	Nine Months Ended September 30,		% Change
	2004	2003	
Direct sales.....	\$ 10,777	\$ 5,292	104%
As a percentage of total net sales.....	40%	26%	
Professional services.....	\$ 8,302	\$ 5,122	62%
As a percentage of total net sales.....	31%	26%	

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OEM/VARs.....	\$ 7,772	\$ 9,756	(20%)
As a percentage of total net sales.....	29%	48%	
 Total net sales.....	 \$ 26,851	 \$ 20,170	 33%

Direct sales consist of software and purchased components delivered in PACS, RIS and RIS/PACS sales to healthcare facilities and imaging centers. The \$5,485 increase in direct sales in the nine months ended September 30, 2004 compared to the nine months ended September 30, 2003 is attributed to revenue recognized on RIS, PACS and RIS/PACS deals closed during the nine months ended September 30, 2004.

Net sales from the professional services group increased \$3,180 in the nine months ended September 30, 2004 compared to the nine months ended September 30, 2003. The net sales growth from the professional services group is due to the growth in sales made directly to healthcare facilities and

imaging centers, where such sales are accompanied by installation services and service contracts. We anticipate net sales from the professional services group to continue to grow as part of the overall growth in sales made directly to healthcare facilities and imaging centers.

Net sales to OEM/VARs and dealers decreased \$1,984 in the nine months ended September 30, 2004 attributed to the long-term OEM component business with one customer in reaching the end of its contractual life in the first quarter of 2004, while the new software product line released for this customer in the second quarter of 2004 has not yet reached sales levels equivalent to the long-term component business and unusually low sales from European VARs in the first two quarters of 2004. We anticipate revenue in the remaining quarter of 2004 to be consistent with the three months ended September 30, 2004.

### Cost of Sales -----

Cost of sales consists of purchased components and service costs associated with net sales, amortization of purchased and developed software and acquired customer contracts.

The cost of purchased components increased to \$3,040 in the nine months ended September 30, 2004 compared to \$2,578 in the nine months ended September 30, 2003, as a result of the purchased components included in RIS/PACS deals recognized under the percentage-of-completion method of contract accounting and PACS only sales during the nine months ended September 30, 2004. Cost of purchased components for the nine months ended September 30, 2003 include only activity since the acquisition date.

The cost of professional services increased to \$4,525 in the nine months ended September 30, 2004 compared to \$2,267 in the nine months ended September 30, 2003. The increase is due to the growing number of RIS, PACS and RIS/PACS sales in 2004 and required headcount growth to install and maintain ongoing service and support for direct sales customers. In addition, we reassigned several presales and technical staff to the professional services group in first three months of 2004 to keep pace with the increased installation demand. Cost of professional services for the nine months ended September 30, 2003 include only costs since the acquisition date. We anticipate that costs

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associated with professional services will continue to increase for the remainder of 2004 to keep pace with the increased installation demand.

Amortization of purchased and developed software increased to \$2,034 in the nine months ended September 30, 2004 compared to \$1,421 in the nine months ended September 30, 2003. As a percentage of net sales, amortization of purchased and developed software remained relatively consistent at 8% in the nine months ended September 30, 2004 compared to 7% in the nine months ended September 30, 2003. The dollar increase in the nine months ended September 30, 2004 is a result of the commencement of amortization on software available for general release and the amortization of the intellectual property and customer contracts acquired in the acquisition of RIS Logic.

### Gross Profit

Gross profit increased 24% to \$17,252 in the nine months ended September 30, 2004 from \$13,904 in the nine months ended September 30, 2003. As a percentage of net sales, gross profit decreased to 64% of net sales in the nine months ended September 30, 2004 compared to 69% in the nine months ended September 30, 2003. The decrease in gross profit as a percentage of sales is due to the increased professional services costs previously discussed and the fact that direct sales in the first two quarters of 2003 consisted of an unusually high percentage of software only PACS sales which resulted in higher than anticipated gross profit.

### Sales and Marketing

Sales and marketing expense increased 14% to \$5,088 in the nine months ended September 30, 2004 from \$4,470 in the nine months ended September 30, 2003. The increase is the result of our objective to invest in sales and marketing activities, particularly for sales team efforts in connection with sales made directly to healthcare facilities and imaging centers. We

anticipate that sales and marketing expense will increase for the remainder of 2004 based on our anticipated presence at our industry's largest tradeshow, RSNA, in late November.

### Product Research and Development

Research and development expense as a percentage of net sales decreased slightly to 5% for the nine months ended September 30, 2004 compared to 7% for the nine months ended September 30, 2003. Research and development expense increased 4% to \$1,464 in the nine months ended September 30, 2004 from \$1,402 in the nine months ended September 30, 2003. Capitalization of software development costs increased \$770 to \$2,672 in the nine months ended September 30, 2004, from \$1,902 in the nine months ended September 30, 2003, as a result of our continued development of FUSION(tm) application modules and further integration of our RIS/PACS technologies during 2004.

### General and Administrative

General and administrative expense as a percentage of net sales remained flat at 12% for the nine months ended September 30, 2004 compared to the nine months ended September 30, 2003. General and administrative expense

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increased 28% to \$3,194 in the nine months ended September 30, 2004 from \$2,487 in the nine months ended September 30, 2003. General and administrative expense includes costs for information systems, accounting, administrative support, management personnel, bad debt expenses and general corporate matters. The \$707 increase is primarily attributed to increased costs associated with corporate compensation, corporate governance and compliance with the Sarbanes - Oxley Act of 2002, as well as recruiting fees associated with the continued hiring of sales and service personnel. We anticipate these costs to continue to increase during the remainder of 2004 as we complete our required documentation and testing under the Sarbanes - Oxley Act of 2002.

### Depreciation and Amortization

-----

Depreciation and amortization expense as a percentage of net sales remained constant at 2% for the nine months ended September 30, 2004 and September 30, 2003. Depreciation and amortization expense increased \$204 to \$587 in the nine months ended September 30, 2004 from \$383 in the three months ended September 30, 2003. Depreciation and amortization is assessed on capital equipment and intangible assets with estimable useful lives. This excludes the amortization of capitalized software, which is a component of cost of sales.

### Other Income, Expense

-----

Our interest expense remained consistent at \$13 in the nine months ended September 30, 2004 compared to \$13 in the nine months ended September 30, 2003, while interest income was \$183 in the nine months ended September 30, 2004 compared to \$60 in the nine months ended September 30, 2003. The increase in interest income is directly attributed to our increased cash and cash equivalent balance throughout the first nine months of 2004 compared to the first nine months of 2003. Other income, net, was \$82 in the nine months ended September 30, 2004 compared to other expense, net of \$169 in the nine months ended September 30, 2003. The other income, net for the nine months ended September 30, 2004 is primarily attributed to the recovery from an insurance claim filed in 2003 for business interruption. The other expense, net for the nine months ended September 30, 2003 is primarily attributed to unrealized foreign exchange losses on United States dollar receivables and cash held in our Canadian subsidiary, where the functional currency is the Canadian dollar.

### Income Taxes

-----

We recorded income tax expense of \$2,083 in the nine months ended September 30, 2004 and \$698 in the nine months ended September 30, 2003. Our estimated domestic and international effective tax rate for 2004 is 29%, compared to the estimated 2003 effective tax rate of approximately 14%. The 2004 effective tax rate was reduced in the three months ended September 30, 2004 as compared to prior quarters by our ability to exclude from United States taxation a portion of the profits associated with the international sales of

our software products. The 2003 effective tax was benefited by the reduction of valuation allowances associated with net operating loss and tax credit carryforwards.

### LIQUIDITY AND CAPITAL RESOURCES

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(in thousands, except for share data)

### Operating Cash Flows

-----

Cash provided by operating activities was \$9,253 in the nine months ended September 30, 2004 compared to \$8,044 in the nine months ended September 30, 2003. Our positive operating cash flow in the nine months ended September 30, 2004 was due primarily to net income of \$5,088, depreciation and amortization expense of \$2,620, a decrease in net deferred income taxes of \$1,176 and an increase in deferred revenue and billings in excess of revenues of \$2,658, offset by a \$1,914 increase in accounts receivable and a \$807 increase in other current and long-term assets.

The total days sales outstanding for the nine months ended September 30, 2004 remained relatively consistent at 105 days compared to 114 days for the nine months ended September 30, 2003.

Although we have recorded income tax expense using a 29% effective income tax rate in 2004, the cash flow impact is expected to be less, due to tax benefits associated with utilizing net operating losses, tax credits and tax deductions associated with certain stock option exercises or disqualifying sales of Common Stock associated with stock options.

### Investing Cash Flows

-----

Cash used in investing activities was \$3,000 in the nine months ended September 30, 2004, due to cash outflows for capitalized software development costs of \$2,672 and purchases of capital equipment of \$328. We expect to continue to invest in software development projects to increase sales.

### Financing Cash Flows

-----

Cash provided by financing activities was \$869 in the nine months ended September 30, 2004. We received net proceeds of \$1,042 from employee and director stock option exercises and \$54 from purchases of our Common Stock by employees under our employee stock purchase plan. We also fully repaid our note payable of \$227 in August 2004.

Total outstanding commitments at September 30, 2004 were as follows:

Contractual Obligations	Total	Less than 1 Year	1 - 3 Years	4 - 6 Years
-----	-----	-----	-----	-----
Operating Leases.....	\$ 3,123	\$ 436	\$ 1,244	\$ 822

In November 2003, we negotiated a new unsecured revolving line of credit agreement with our bank, increasing our line to \$15 million from \$5 million effective November 21, 2003, and maturing December 31, 2006. The interest rate on the line of credit is at a variable rate that is equal to the prime rate as published in The Wall Street Journal, less 0.75 percentage points. At September 30, 2004, the loan's interest rate was 4.0%. No amounts were outstanding on the line of credit as of September 30, 2004.

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We do not have any other significant long-term obligations, contractual obligations, lines of credit, standby letters of credit, standby repurchase obligations or other commercial commitments.

We believe that existing cash, together with the availability under our revolving line of credit and future cash flows from operations will be sufficient to execute our business plan in 2004. However, any projections of future cash inflows and outflows are subject to uncertainty. In 2004, it may

be necessary to raise additional capital for activities necessary to meet our business objectives or our long-term liquidity needs. If it is determined that additional capital is needed, it may be raised by selling additional equity or raising debt from third party sources. The sale of additional equity or convertible debt securities could result in dilution to current stockholders. In addition, debt financing, if available, could involve restrictive covenants, which could adversely affect operations. There can be no assurance that any of these financing alternatives, including raising additional capital, will be available in amounts or on terms acceptable to us.

### CRITICAL ACCOUNTING POLICIES

Our consolidated financial statements are impacted by the accounting policies used and the estimates and assumptions made by management during their preparation. Critical accounting policies in which management makes significant estimates are revenue recognition, accounts receivable, software capitalization, goodwill and intangible asset valuation, other long-lived assets and income taxes.

#### Revenue Recognition

-----

Revenues are derived primarily from the sublicensing and licensing of computer software, installations, training, consulting, software maintenance and sales of PACS, RIS and RIS/PACS solutions. 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. 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. 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 stated in the contract, and fair value of the installation based upon the price charged when the services are sold separately. If evidence of the fair value cannot be established for

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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 sales of RIS and from RIS/PACS solutions sold directly to customers, where professional services are considered essential to the functionality of the solution sold, is recognized on a 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 takes 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.

Revenue from sublicenses sold on an individual basis and computer 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.

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

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.

### Accounts Receivable

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Our accounts receivable balance is reported net of an allowance for bad debts. Our management determines collection risk and records allowances for bad debts based on the aging of accounts and past transaction history with customers. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.

### Software Capitalization

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Software capitalization commences when management determines that projects have achieved technological feasibility. Management's determination that a project has achieved technological feasibility does not ensure that the project can be commercially salable. Amounts capitalized include direct labor and estimates of overhead attributable to the projects. The useful lives of capitalized software projects are assigned by management, based upon the expected life of the software. Management also estimates the realizability of capitalized values based on projections of future net operating cash flows through the sale of products related to each capitalized project. If we



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determine in the future that the value of capitalized software cannot be recovered, a write down of the value of the capitalized software to its recoverable value may be required. If the actual achieved revenues are lower than our estimates or the useful life of a project is shorter than the estimated useful life, the asset may be deemed to be impaired and, accordingly, a write down of the value of the asset or a shorter amortization period may be required.

### Other Long-Lived Assets

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Other long-term assets, including property and equipment, and other intangibles, are amortized over their expected lives, which are estimated by management. Management also makes estimates of the impairment of long-term assets whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If the actual useful life of a long-term asset is shorter than the useful life estimated by us, the assets may be deemed to be impaired and, accordingly, a write down of the value of the assets may be required.

### Goodwill and Other Intangible Assets

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Effective January 1, 2002, we adopted SFAS No. 142, Goodwill and Other Intangible Assets ("SFAS No. 142"). SFAS No. 142 requires that goodwill and indefinite lived intangible assets be reviewed for impairment annually, or more frequently if impairment indicators arise. Our policy provides that goodwill and indefinite lived intangible assets will be reviewed for impairment as of December 31 of each year. In calculating potential impairment losses, we evaluated the fair value of goodwill and intangible assets by estimating the expected present value of their future cash flows. The future cash flows are based upon management's assumptions about future sales activity and market acceptance of our products. If these assumptions change, we may be required to write down the carrying value of the asset to a revised amount or shorten the amortization period.

### Income Taxes

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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. Significant management judgment is required in determining our provision for income taxes, deferred tax assets and liabilities.

## FACTORS THAT MAY AFFECT FUTURE RESULTS OF OPERATIONS, FINANCIAL CONDITION OR BUSINESS

Quarterly Operating Results May Vary - Our quarterly operating results have varied in the past and may continue to vary in future periods. Quarterly operating results may vary for a number of reasons, including accounting policy changes mandated by regulating entities (including, but not limited to, any accounting policy change concerning the expensing of options), demand for our software solutions and services, our sales cycle, and other factors described in this section and elsewhere in this report. As a result of healthcare

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industry trends and the market for our RIS, PACS or RIS/PACS solutions, a large percentage of our revenues are generated by the sale and installation of systems sold directly to healthcare institutions. The sale may be subject to delays due to clients' internal budgets and procedures for approving capital expenditures and by competing needs for other capital expenditures and deploying new technologies or personnel resources. Delays in the expected sale or installation of these contracts may have a significant impact on our anticipated quarterly revenues and consequently our earnings, since a significant percentage of our expenses are relatively fixed.

In addition, software revenue from sales of PACS solutions are generally recognized at the time of shipment to our customers. Software revenue from sales of RIS and RIS/PACS solutions are recognized on the percentage-of-completion method as the installation services are performed. As a result, significant changes in the sales mix of our FUSION(tm) solutions may have an impact on our quarterly revenues and consequently, our earnings.

Stock Price May Be Volatile - The trading price of our Common Stock may be volatile. The market for our Common Stock may experience significant price and volume fluctuations in response to a number of factors including actual or anticipated quarterly variations in operating results, rumors about our performance or software solutions, changes in expectations of future financial performance or changes in estimates of securities analysts, governmental regulatory action, healthcare reform measures, client relationship developments, changes occurring in the securities markets in general and other factors, many of which are beyond our control. As a matter of policy, we do not generally comment on rumors.

Furthermore, the stock market in general, and the market for software, healthcare and technology companies in particular, has experienced volatility that often has been unrelated to the operating performance of particular companies. These broad market and industry fluctuations may adversely affect the trading price of our Common Stock, regardless of actual operating performance.

Changes in the Healthcare Industry - The healthcare industry is highly regulated and is subject to changing political, economic and regulatory influences. For example, the Health Insurance Portability and Accountability Act of 1996 (HIPAA) has impacted the healthcare industry by requiring identifiers and standardized transactions/code sets and necessary security and privacy measures in order to ensure the protection of patient health information. These factors affect the purchasing practices and operation of healthcare organizations. Federal and state legislatures have periodically considered programs to reform the United States of America healthcare system at both the federal and state level and to change healthcare financing and reimbursement systems. These programs may contain proposals to increase governmental involvement in healthcare, lower reimbursement rates or otherwise change the environment in which healthcare industry participants operate. Healthcare industry participants may respond by reducing their investments or postponing investment decisions, including investments in our software solutions and services.

Significant Competition - The market for RIS, PACS and RIS/PACS systems is competitive and subject to technological change. We believe that the principal competitive factors in this market include the breadth and quality of system and software solution offerings, the stability of the systems provider, the features and capabilities of the information system, the ongoing support for the system and the potential for enhancements and future compatible software solutions. Certain of our competitors have greater financial, technical, product development, marketing and other resources than us and some of our competitors offer software solutions that we do not offer.

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Proprietary Technology May Be Subjected to Infringement Claims or May Be Infringed Upon - We rely upon a combination of license agreements, confidentiality procedures, employee nondisclosure agreements and technical measures to maintain the confidentiality and trade secrecy of our proprietary information. We also rely on trademark and copyright laws to protect our

intellectual property. We currently have a very limited patent portfolio. As a result, we may not be able to protect against misappropriation of our intellectual property.

In addition, we could be subject to intellectual property infringement claims as the number of competitors grow and the functionality of our software solutions and services overlap with competitive offerings. These claims, even if not meritorious, could be expensive to defend. If we become liable to third parties for infringing their intellectual property rights, we could be required to pay a substantial damage award and to develop noninfringing technology, obtain a license or cease selling the software solutions that contain the infringing intellectual property.

Dependence on Key Employees - Our continued success will depend to a significant degree upon the efforts and abilities of our senior management, in particular, Richard A. Linden, our President and Chief Executive Officer. We carry key man life insurance in the amount of \$5 million on Richard A. Linden and \$2 million on Scott T. Veech, our Chief Financial Officer. We do not carry key man life insurance on any other of our officers or directors. The loss of the services of any of these persons could have a material adverse effect on us.

Government Regulation - We are subject to regulation by the United States of America Food and Drug Administration ("FDA"). If our software solutions are deemed to be actively regulated medical devices by the FDA, we could be subject to more extensive requirements governing pre- and post-marketing requirements. Complying with these FDA regulations could be time consuming and expensive. It is possible that the FDA may become more active in regulating computer software that is used in healthcare.

Following an inspection by the FDA in November of 2003, we received a FDA warning letter and Form 483 (Notice of Inspectional Observations) listing observations of non-compliance with certain aspects of the FDA's Quality System Regulation. In August 2004, we received a visit by the FDA to review a number of corrective actions undertaken in response to the Form 483 and the FDA warning letter. The FDA had two additional observations remaining, which we are currently addressing.

There can be no assurance, however, that our actions taken to date in response to the Form 483 and warning letter will be deemed adequate by the FDA or that additional actions will not be required by us. In addition, we remain subject to periodic FDA inspections and there can be no assurances that we will not be required to undertake additional actions to comply with the Federal Food, Drug and Cosmetic Act ("Act") and any other applicable regulatory requirements. Any failure by us to comply with the Act and any other applicable regulatory requirements could have a material adverse effect on our ability to continue to manufacture and distribute our software solutions. The FDA has many enforcement tools including recalls, seizures, injunctions, civil fines and/or criminal prosecutions. Any of the foregoing could have a material adverse effect on our business, results of operations or financial condition.

Product Related Liabilities - Many of our software solutions provide

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data for use by healthcare providers in providing care to patients. Although no such claims have been brought against us to date regarding injuries related to the use of our software solutions, such claims may be made in the future. Although we maintain product liability insurance coverage in an amount that we believe is sufficient for our business, there can be no assurance that such coverage will cover a particular claim that may be brought in the future, prove to be adequate or that such coverage will continue to remain available on acceptable terms, if at all. A successful claim brought against us, which is uninsured or underinsured, could materially harm our business, results of operations or financial condition.

Risks Associated with Our Global Operations - We market, sell and service our software solutions globally. We have established offices around the world, including North America, the Netherlands and Japan. We will continue to expand our global operations and enter new global markets. This expansion will require significant management attention and financial resources to develop successful indirect global sales and support channels. Our success will depend, in part, on our ability to form relationships with local partners. For these reasons, we may not be able to maintain or increase global market demand for our software solutions.

Global operations are subject to inherent risks, and our future results could be adversely affected by a variety of uncontrollable and changing factors. These include:

- \* Greater difficulty in collecting accounts receivable and longer collection periods.
- \* The impact of economic conditions outside the United States of America.
- \* Changes in foreign currency exchange.
- \* Unexpected changes in regulatory requirements.
- \* Certification requirements.
- \* Reduced protection of intellectual property rights in some countries.
- \* Potentially adverse tax consequences.
- \* Political instability.
- \* Trade protection measures and other regulatory requirements.
- \* Service provider and government spending patterns.
- \* Natural disasters, war or terrorist acts.
- \* Poor selection of a partner in a country.
- \* Political conditions which may threaten the safety of associates or our continued presence in foreign countries.

Concentrations - Substantially all of our cash and cash equivalents are held at one United States of America financial institution. Deposits held with the bank exceed the amount of insurance provided on such deposits. Generally

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these deposits may be redeemed upon demand and, therefore, bear minimal risk. Substantially all of our clients are imaging centers, hospitals and integrated delivery networks. If significant adverse macro-economic factors were to impact these organizations, it could materially adversely affect us. Our access to certain software and hardware components is dependent upon single and sole source suppliers. The inability of any supplier to fulfill our supply requirements could affect future results.

### MATERIAL OFF-BALANCE SHEET ARRANGEMENTS

We have no material off balance sheet arrangements.

### ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

**Interest Rate Risk.** Our cash equivalents are exposed to financial market risk due to fluctuations in interest rates, which may affect our interest income. As of September 30, 2004, our cash equivalents and short-term investments include money market funds and short term deposits totaling approximately \$24 million, and earned interest at a weighted average rate of 1.3%. The value of the principal amounts is equal to the fair value for these instruments. Due to the relative short-term nature of our investment portfolio, our interest income is vulnerable to sudden changes in market interest rates. We do not use our portfolio for trading or other speculative purposes.

**Foreign Currency Exchange Risk.** We have sales and expenses in Canada and Europe that are denominated in currencies other than the United States dollar and as a result have exposure to foreign currency exchange risk. We do not currently enter into forward exchange contracts to hedge exposures denominated in foreign currencies or any other derivative financial instruments for trading or speculative purposes. However, in the event our exposure to foreign currency risk increases to levels that we do not deem acceptable, we may choose to hedge those exposures.

### ITEM 4. CONTROLS AND PROCEDURES

Our Chief Executive Officer and Chief Financial Officer have concluded, based on their evaluation as of September 30, 2004, that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) are effective for gathering, analyzing and disclosing the information we are required to disclose in our reports filed under the Exchange Act. There have been no significant changes in our internal controls or in

other factors that could significantly affect these controls subsequent to the date of the previously mentioned evaluation.

### INTERNAL CONTROL OVER FINANCIAL REPORTING

There have not been any changes in our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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### ITEM 1. LEGAL PROCEEDINGS

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 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.

### ITEM 2. CHANGES IN SECURITIES, USE OF PROCEEDS AND ISSUER PURCHASES OF EQUITY SECURITIES

- (a) None.
- (b) Not applicable.
- (c) None.

### ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not applicable.

### ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

### ITEM 5. OTHER INFORMATION

- (a) On August 24, 2003, we announced a stock repurchase plan providing for the purchase of up to \$10 million of our Common Stock. Purchases may be made over a period of two years and the timing, price and volume of repurchases will be based on market conditions, applicable securities laws and other factors.
- (b) None.

### ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

- (a) Exhibits  
See Exhibit Index.

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- (b) On July 28, 2004, we filed a Form 8-K to report in Item 12, press release announcing financial results for the second quarter of our fiscal year 2004.

### SIGNATURES

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Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Registrant:

MERGE TECHNOLOGIES INCORPORATED

November 8, 2004

By: /s/ Richard A. Linden

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Richard A. Linden  
President and Chief Executive Officer

November 8, 2004

By: /s/ Scott T. Veech

-----  
Scott T. Veech  
Chief Financial Officer, Secretary and  
Treasurer (Principal Financial  
Officer and Principal Accounting  
Officer)

### EXHIBIT INDEX

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- 2.1 Merger Agreement by and among Merge Technologies Incorporated, RL Acquisition Corp, RIS Logic Incorporated, and the Principal Shareholders of RIS Logic Incorporated dated July 9, 2003(14)
- 3.1 Articles of Incorporation of Registrant(2), Articles of Amendment as filed on December 28, 1998(3), Articles of Amendment as filed on September 2, 1999(6), Articles of Amendment as filed on February 23, 2001(6), and Articles of Amendment as filed on August 9, 2002(15)
- 3.2 Amended and Restated Bylaws of Registrant as of February 3, 1998(1)
- 10.1 Employment Agreement entered into as of March 1, 2004, between Registrant and Richard A. Linden(15)
- 10.2 Employment Agreement entered into as of March 1, 2004, between Registrant and William C. Mortimore(15)
- 10.3 Employment Agreement entered into as of March 1, 2004, between

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- Registrant and Scott T. Veech(15)
- 10.4 Employment Agreement entered into as of March 1, 2004, between Registrant and David M. Noshay(15)
- 10.5 Employment Agreement entered into as of July 17, 2003, between Registrant and Daniel H. Quigg
- 10.6 1996 Stock Option Plan for Employees of Registrant dated May 13, 1996(2), as amended and restated in its entirety as of September 1, 2003(10)
- 10.7 Office Lease for West Allis Center dated May 24, 1996, between Registrant and Whitnall Summit Company, LLC, Supplemental Office Lease dated July 3, 1997(1), Supplemental Office Space Lease dated January 30, 1999(2), Supplemental Office Space Lease for 1126 West Allis Operating Associates Limited Partnership dated April 11, 2000(4) and Second Amendment to Lease dated January 11, 2002, between Registrant and 1126 West Allis Operating Associates, Limited Partnership(7)
- 10.8 1998 Stock Option Plan For Directors(1)
- 10.9 2003 Stock Option Plan of Registrant dated September 24, 2003, and effective July 17, 2003(10)
- 10.10 Merge Technologies Incorporated 2000 Employee Stock Purchase Plan, as amended(5)
- 10.11 Loan Agreement dated as of November 21, 2003, by and between Registrant and Lincoln State Bank(15)
- 10.12 Asset Purchase Agreement by and among Signal Stream, Inc., a wholly owned subsidiary of Merge Technologies Incorporated, and Aurora Technology Inc., entered into as of April 18, 2002(12)
- 31.1 Certification of Chief Executive Officer Pursuant to Section 13(a) of the Securities Exchange Act of 1934
- 31.2 Certification of Chief Financial Officer Pursuant to Section 13(a) of the Securities Exchange Act of 1934
- 32 Certification of Chief Executive Officer and Chief Financial Officer Pursuant to Section 13(a) of the Securities Exchange Act of 1934 (Section 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes - Oxley Act of 2002)
- 99.1 Code of Ethics(15)
- 99.2 Whistleblower Policy(15)

- 
- (1) Incorporated by reference from Annual Report on Form 10-KSB for the fiscal year ended December 31, 1997.
- (2) Incorporated by reference from Registration Statement on Form SB-2 (No. 333-39111) effective January 29, 1998.
- (3) Incorporated by reference from Quarterly Report on Form 10-QSB for the three months ended September 30, 1999.
- (4) Incorporated by reference from Quarterly Report on Form 10-QSB for the three months ended September 30, 2000.



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- (5) Incorporated by reference from Proxy Statement for 2000 Annual Meeting of Shareholders dated May 9, 2000.
- (6) Incorporated by reference from Annual Report on Form 10-KSB for the fiscal year ended December 31, 2000.
- (7) Incorporated by reference from Annual Report on Form 10-KSB for the fiscal year ended December 31, 2001.
- (8) Incorporated by reference from Annual Report on Form 10-KSB for the fiscal year ended December 31, 2002.
- (9) Incorporated by reference from Quarterly Report on Form 10-Q for the three months ended September 30, 2003.
- (10) Incorporated by reference from Quarterly Report on Form 10-Q for the three months ended September 30, 2003.
- (11) Incorporated by reference from Current Report on Form 8-K dated September 3, 1999.
- (12) Incorporated by reference from Current Report on Form 8-K dated May 22, 2002.
- (13) Incorporated by reference from Current Report on Form 8-K dated September 28, 2002.
- (14) Incorporated by reference from Current Report on Form 8-K dated July 17, 2003.
- (15) Incorporated by reference from Annual Report on Form 10-K for the fiscal year ended December 31, 2003.

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EXHIBIT 31.1  
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### CERTIFICATION

Pursuant to Section 302 of the Sarbanes - Oxley Act of 2002

I, Richard A. Linden, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Merge Technologies Incorporated (the "Registrant");
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the Registrant as of, and for, the periods presented in this quarterly report;

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4. The Registrant's other certifying officer and I (herein, the "Certifying Officers") are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the Registrant and have:
- (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Registrant, including its consolidated subsidiaries (collectively, the "Company"), is made known to the Certifying Officers by others within the Company, particularly during the period in which this quarterly report is being prepared; and
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles; and
  - (c) Evaluated the effectiveness of the Registrant's disclosure controls and procedures and presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this quarterly report based on such evaluation; and
  - (d) Disclosed in this quarterly report any change in the Registrant's internal control over financial reporting that occurred during the Registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Registrant's internal control over financial reporting; and
5. The Registrant's Certifying Officers have disclosed, based on the Certifying Officers' most recent evaluation of internal control over financial reporting, to the Registrant's auditors and the Audit Committee of the Registrant's Board of Directors:
- (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the Registrant's internal control over financial reporting.

Date: November 8, 2004

/s/ Richard A. Linden

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Richard A. Linden, Chief Executive Officer

See also the certification pursuant to Section 906 of the Sarbanes - Oxley Act of 2002, which is included as an exhibit to this report.

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EXHIBIT 31.2  
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### CERTIFICATION

Pursuant to Section 302 of the Sarbanes - Oxley Act of 2002

I, Scott T. Veech, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Merge Technologies Incorporated (the "Registrant");
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the Registrant as of, and for, the periods presented in this quarterly report;
4. The Registrant's other certifying officer and I (herein, the "Certifying Officers") are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the Registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Registrant, including its consolidated subsidiaries (collectively, the "Company"), is made known to the Certifying Officers by others within the Company, particularly during the period in which this quarterly report is being prepared; and
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles; and
  - (c) Evaluated the effectiveness of the Registrant's disclosure controls and procedures and presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this quarterly report based on such evaluation; and
  - (d) Disclosed in this quarterly report any change in the Registrant's internal control over financial reporting that occurred during the Registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Registrant's internal control over financial reporting; and
5. The Registrant's Certifying Officers have disclosed, based on the

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Certifying Officers' most recent evaluation of internal control over financial reporting, to the Registrant's auditors and the Audit Committee of the Registrant's Board of Directors:

- (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Registrant's ability to record, process, summarize and report financial information; and
- (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the Registrant's internal control over financial reporting.

Date: November 8, 2004

/s/ Scott T. Veech

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Scott T. Veech, Chief Financial Officer

See also the certification pursuant to Section 906 of the Sarbanes - Oxley Act of 2002, which is included as an exhibit to this report.

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EXHIBIT 32  
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CERTIFICATION of CHIEF EXECUTIVE OFFICER and CHIEF FINANCIAL OFFICER

Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to  
Section 906 of the Sarbanes - Oxley Act of 2002

In connection with the Quarterly Report on Form 10-Q of MERGE TECHNOLOGIES INCORPORATED (the "Company") for the quarterly period ended September 30, 2004, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), Richard A. Linden, as Chief Executive Officer of the Company, and Scott T. Veech, as Chief Financial Officer of the Company, each hereby certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes - Oxley Act of 2002, that, to the best of their knowledge:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: November 8, 2004

By: /s/ Richard A. Linden

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Richard A. Linden  
Chief Executive Officer

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Date: November 8, 2004

By: /s/ Scott T. Veech

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Scott T. Veech  
Chief Financial Officer

This certification accompanies the Report pursuant to Section 906 of the Sarbanes - Oxley Act of 2002 and shall not, except to the extent required by the Sarbanes - Oxley Act of 2002, be deemed filed by the Company for purposes of Section 18 of the Securities Exchange Act of 1934, as amended.

See also the certifications pursuant to Section 302 of the Sarbanes - Oxley Act of 2002, which are included in this quarterly report on Form 10-Q.

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EXHIBIT 10.5  
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## EMPLOYMENT AGREEMENT

THIS EMPLOYMENT AGREEMENT ("Agreement") is made and entered into as of July 17, 2003 by and among DANIEL H. QUIGG (the "Executive"), MERGE TECHNOLOGIES INCORPORATED, a Wisconsin corporation ("Merge"), and RISLOGIC, INC., a Delaware corporation ("Operating Sub" or "RISlogic Division"). The terms of this Agreement shall supercede the terms of the Employment Agreement between the Executive and Binnacle LLC, an Ohio limited liability company (together with its successor by merger, RIS Logic Incorporated, an Ohio corporation, hereinafter sometimes referred to as "RIS Logic") dated November 21, 2000. Merge and Operating Sub are hereinafter sometimes referred to as "the Merge Companies."

### R E C I T A L S:

A. The Merge Companies are engaged in the provisioning of medical diagnostic imaging workflow software solutions, often referred to as Picture Archiving and Communication Systems ("PACs") and Radiology Information Systems ("RIS"), and professional consulting associated with the provisioning of these software solutions for healthcare facilities, Original Equipment Manufacturers ("OEMs") and Value Added Resellers ("VARs"). Such business together with the business in which RIS Logic has been engaged in prior to the date hereof is hereinafter collectively referred to as the "Business"; and

B. As part of the transactions contemplated by that certain Merger Agreement dated July 9, 2003 (the "Merger Agreement") whereby RIS Logic has been merged into Operating Sub on the date hereof (the "Merger"), the Merge Companies desire to employ the Executive and the Executive desires to accept such employment;

NOW THEREFORE, in consideration of the promises, mutual covenants and agreements contained herein, and for other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the Merge Companies and the Executive do hereby agree as follows:

1. Employment and Duties. On the terms and subject to the conditions set forth in this Agreement, Merge agrees to employ the Executive as Vice President, and the RISlogic Division, Inc. agrees to employ the Executive as President, to perform such duties as are consistent with such position(s) as

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may be assigned, from time to time, by the Board of Directors (the "Board"), Chief Executive Officer of Merge, the Senior Vice President of Merge or the Board of Directors of Operating Sub, and to render such additional services and discharge such other responsibilities as such boards, the Chief Executive Officer or the Senior Vice President of Merge may, from time to time, stipulate consistent with such senior management position. In no event shall Executive perform a senior policy making function for Merge.

2. Performance. The Executive accepts the employment described in Section 1 of this Agreement and agrees to devote substantially all of his working time and efforts to the faithful and diligent performance of the services described herein, including the performance of such other services and responsibilities as the Board(s), Chief Executive Officer or

Senior Vice President of Merge may, from time to time, stipulate consistent with such senior management position.

3. Term. The term of employment shall commence on the date hereof (the "Commencement Date"). The term of employment shall remain in effect until terminated by either Executive or the Merge Companies by giving thirty (30) days written notice of termination. The period of time in which Executive is employed shall constitute the "Employment Period," and each calendar year or portion of a calendar year during the Employment Period is hereinafter sometimes referred to as a "Year."

4. Salary. For all the services to be rendered by the Executive hereunder, the Merge Companies agree to pay a salary at a rate of no less than \$135,000 US per annum ("Salary"), payable in the manner and frequency in which the Merge Companies' payroll is customarily handled, and subject to annual review at the time annual reviews of the salaries of other senior executive officers are to be conducted. Executive acknowledges that he has received all compensation due to him from RIS Logic up to the Merge Agreement date.

5. Bonus. The Executive shall be eligible for an annual performance bonus of up to 20% of Salary, dependent on achievement of Merge and individual performance targets. As an elected officer of Merge, adjustments to compensation package, including base pay, annual bonus and annual stock option awards, will be recommended by the Chief Executive Officer of Merge and subject to approval of the Board of Directors of Merge or appropriate committee thereof. For each Year the annual performance bonus is to be paid, it shall be paid within thirty (30) days of the completion of the year-end financial statements for that Year, but in no event later than May 31 of the following year. The Chief Executive Officer of Merge, subject to approval of the Board of Directors or appropriate committee thereof, in its sole discretion may change the bonus target annually and any dispute as to whether Executive met the performance targets for a Year shall be determined conclusively by the Chief Executive Officer and Executive Committee of the Board. If this Agreement is executed mid-year, then performance targets will be established for the remainder of the year and the performance bonus will be prorated for the portion of the Year that remains.

6. Paid Time Off. The Executive shall be entitled to paid time off for vacation, illness, holiday and personal reasons in accordance with Merge's paid time off policy at the rate offered to similar executives of Merge with similar tenure.

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7. Disability Benefit. If at any time during the Employment Period the Executive is unable to perform fully the material and substantial duties hereunder by reason of illness, accident, or other disability (as confirmed by competent medical evidence by a physician selected by the Executive Committee), the Executive shall be entitled to receive periodic payments of Salary to which he would otherwise be entitled pursuant to Section 4 of this Agreement by reason of his employment for a period of ninety (90) days. Notwithstanding the foregoing provision (i) the amounts payable to the Executive pursuant to this Section 7 shall be reduced by any amounts received by the Executive with respect to any such incapacity pursuant to any insurance policy, plan, or other employee benefit provided to the Executive by the Merge Companies; and (ii) in no event will the terms of this Agreement supersede any health or disability benefit to which Executive is entitled under applicable state or federal law.

8. Executive Options. In connection with the Merger, Executive will receive new stock options for 0 shares of Merge common stock on the date hereof. The Executive will receive rollover stock options as part of the Merger consistent with the conversion formula that applies to all RIS Logic employee options. Additional stock options may be awarded on an annual basis pending recommendation by the Chief Executive Officer of Merge and approved by the Board.

9. Other Benefits. Except as otherwise specifically provided herein, during the Employment Period, the Executive shall be eligible for all non-wage benefits the Company provides generally for its other salaried employees.

10. Business Expenses.

(a) Reimbursement. Merge shall reimburse the Executive for the reasonable, ordinary, and necessary business expenses incurred by him in connection with the performance of his duties hereunder, including, but not limited to, ordinary and necessary travel expenses and entertainment expenses and mobile phone expenses.

(b) Accounting. The Executive shall provide Merge with an accounting of his expenses, which accounting shall clearly reflect which expenses are reimbursable by the Merge. The Executive shall provide the Merge with such other supporting documentation and other substantiation of reimbursable expenses as will conform to Internal Revenue Service or other requirements. All such reimbursements shall be payable by the Merge to the Executive promptly after receipt by Merge of appropriate documentation therefor.

11. Surrender of Properties. Upon termination of the Executive's employment with the Merge Companies, regardless of the cause therefor, the Executive shall promptly surrender to the Merge Companies all property provided him by the Merge Companies or RIS Logic for use in relation to his employment, and, in addition, the Executive shall surrender to the Merge Companies any and all confidential sales materials, lists of customers and prospective customers, price lists, files, patent applications, records, models, or other materials and information of or pertaining to the Merge Companies, RIS Logic or their customers or prospective customers or the products, Business, and operations of the Merge Companies and RIS Logic in his possession.

12. Termination and Severance. In the event that the Executive is terminated by the Merge Companies for any reason other than gross negligence, commission of a felony, disability, death or following Executive's

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giving of notice to the Company that he intends to terminate this Agreement, the Company shall pay the Executive, as a severance allowance, an amount equal to three (3) months of his/her then current Salary, unless the termination occurs within 12 months of the Commencement Date in which the severance allowance will be six (6) months of his/her then current Salary.

13. Inventions and Secrecy. Except as otherwise provided in this Section 13, the Executive:

(a) shall hold in a fiduciary capacity for the benefit of the Merge Companies all secret or confidential information, knowledge, or data of the Merge Companies, RIS Logic or the Business or production operations

obtained by the Executive during his employment by the Merge Companies or RIS Logic, which shall not be generally known to the public or recognized as standard practice (whether or not developed by the Executive) and shall not, during his employment by the Merge Companies and after the termination of such employment for any reason, communicate or divulge any such information, knowledge or data to any person, firm or corporation other than the Merge Companies or persons, firms or corporations designated by the Merge Companies;

(b) shall promptly disclose to the Merge Companies all inventions, ideas, devices, and processes made or conceived by him alone or jointly with others, from the time of entering RIS Logic's or the Merge Companies' employ until such employment is terminated, relevant or pertinent in any way, whether directly or indirectly, to the Business or production operations or resulting from or suggested by any work which he may have done for the Merge Companies or RIS Logic or at their request;

(c) shall, at all times during his employment with the Merge Companies, assist the Merge Companies (entirely at the Merge Companies' expense) to obtain and develop for the Merge Companies' benefit patents on such inventions, ideas, devices and processes, whether or not patented; and

(d) shall do all such acts and execute, acknowledge and deliver all such instruments as may be necessary or desirable in the opinion of the Merge Companies to vest in the Merge Companies the entire interest in such inventions, ideas, devices, and processes referred to above.

The foregoing to the contrary notwithstanding, the Executive shall not be required to assign or offer to assign to the Merge Companies any of the Executive's rights in any invention for which no equipment, supplies, facility, or trade secret information of the Merge Companies or RIS Logic was used and which was developed entirely on the Executive's own time, unless: (A) the invention related to (i) the Business; or (ii) the Merge Companies' actual or demonstrably anticipated (with the realistic prospect of occurring) research or development; or (B) the invention results from any work performed by the Executive for the Merge Companies or RIS Logic. The Executive acknowledges his prior receipt of written notification of the limitation set forth in the preceding sentence on the Executive's obligation to assign or offer to assign to the Merge Companies the Executive's rights in inventions.

14. Confidentiality of Information: Duty of Non-Disclosure.

(a) The Executive acknowledges and agrees that his employment by the Merge Companies under this Agreement necessarily involves his understanding of and access to certain trade secrets and confidential information pertaining to the Business of the Merge Companies and RIS Logic.



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Accordingly, the Executive agrees that after the date of this Agreement at all times he will not, directly or indirectly, without the express consent of Merge, disclose to or use for the benefit of any person, corporation or other entity, or for himself any and all files, trade secrets or other confidential information concerning the internal affairs of the Merge Companies and RIS Logic, including, but not limited to, information pertaining to its customers,

prospective customers, services, products, earnings, finances, operations, methods or other activities, provided, however, that the foregoing shall not apply to information which is of public record or is generally known, disclosed or available to the general public or the industry generally, or known by Executive prior to his employment with the Merge Companies and RIS Logic. Further, the Executive agrees that he shall not, directly or indirectly, remove or retain, without the express prior written consent of the Merge Companies, and upon termination of this Agreement for any reason shall return to the Merge Companies, any confidential figures, calculations, letters, papers, records, computer disks, computer print-outs, lists, documents, instruments, drawings, designs, programs, brochures, sales literature, or any copies thereof, or any information or instruments derived therefrom, or any other similar information of any type or description, however such information might be obtained or recorded, arising out of or in any way relating to the Business or obtained as a result of his employment by the Merge Companies or RIS Logic. The Executive acknowledges that all of the foregoing are proprietary information, and are the exclusive property of the Merge. The covenants contained in this Section 14 shall survive the termination of this Agreement.

(b) The Executive agrees and acknowledges that the Merge Companies do not have any adequate remedy at law for the breach or threatened breach by the Executive of his covenant, and agrees that the Merge Companies shall be entitled to injunctive relief to bar the Executive from such breach or threatened breach in addition to any other remedies which may be available to the Merge at law or in equity.

### 15. Covenant Not to Compete and Non-solicitation.

(a) During Employment Period. During the Employment Period, the Executive shall not, without the prior written consent of Merge, which consent may be withheld at the sole and reasonable discretion of Merge, engage in any other business activity for gain, profit, or other pecuniary advantage (excepting the investment of funds in such form or manner as will not require any services on the part of the Executive in the operation of the affairs of the companies in which such investments are made) or engage in or in any manner be connected or concerned, directly or indirectly, whether as an officer, director, stockholder, partner, owner, employee, creditor, or otherwise, with the operation, management, or conduct of any business that competes with the Business.

(b) Following Termination of Employment Period. During the Employment Period and during the five (5) year period immediately following the end of the Employment Period (and three (3) year period in the case of solicitation of employment as specified in (c) below), regardless of the reason therefor, the Executive shall not, without the prior written consent of Merge, which consent may be withheld at the sole discretion of Merge: (A) engage in or in any manner be connected or concerned, directly or indirectly, whether as an officer, director, stockholder, partner, owner, employee, creditor, or otherwise with the operation, management, or conduct of any business similar to the Business; or (B) directly solicit, contact,

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interfere with, or divert any customer served by the Merge Companies or RIS Logic, or any prospective customer identified by or on behalf of the Merge Companies or RIS Logic, during the Executive's employment with the Merge Companies and RIS Logic.

(c) Non-Solicitation. During the Employment Period and during the three (3) year period following the end of the Employment Period, Executive will not, except as set forth in Section 6.5 (including Schedule 6.5)

of the Merger Agreement, solicit or hire any employee or independent contractor then employed by the Merge Companies or previously employed by the Merge Companies or RIS Logic within the one year period preceding termination of the Executive's employment with the Merge Companies to join the Executive, whether as a partner, agent, employee, independent contractor or otherwise, in any enterprise.

(d) Acknowledgment. The Executive acknowledges that the restrictions set forth in Section 15 are reasonable in scope and essential to the preservation of the Business of the Merge Companies and proprietary properties and that the enforcement thereof will not in any manner preclude the Executive, in the event of the Executive's termination of employment with the Merge Companies, from becoming gainfully employed in such manner and to such extent as to provide a standard of living for himself, the members of his family, and those dependent upon him of at least the sort and fashion to which he and they have become accustomed and may expect. Executive further acknowledges that the Merge Companies conduct the Business worldwide and that the covenants contained herein are a material inducement for the Merge Companies to consummate the Merger.

(e) Severability. The covenants of the Executive contained in Section 15 of this Agreement shall each be construed as an agreement independent of any other provision in this Agreement, and the existence of any claim or cause of action of the Executive against the Merge Companies, whether predicated on this Agreement or otherwise, shall not constitute a defense to the enforcement by the Merge Companies of such covenants. Both parties hereby expressly agree and contract that it is not the intention of either party to violate any public policy, or statutory or common law, and that if any sentence, paragraph, clause, or combination of the same of this Agreement is in violation of the law, such sentence, paragraph, clause or combination of the same shall be void, and the remainder of such paragraph and this Agreement shall remain binding on the parties to make the covenants of this Agreement binding only to the extent that it may be lawfully done. In the event that any part of any covenant of this Agreement is determined by a court of law to be overly broad thereby making the covenant unenforceable, the parties hereto agree, and it is their desire, that such court shall substitute a judicially enforceable limitation in its place, and that as so modified the covenant shall be binding upon the parties as if originally set forth herein.

### 16. Arbitration.

(a) Subject to the terms of Section 17(h) below, upon presentation of a written claim or claims (collectively "Claims") arising out of or relating to this Agreement, or the breach hereof, by an aggrieved party, the other party shall have thirty (30) days in which to make such inquiries of the aggrieved party and conduct such investigations as it believes reasonably necessary to determine the validity of the Claims. At the end of such period of investigation, the complained of party shall either pay the amount of the Claims or the arbitration proceeding described in Section 16(b) shall be

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invoked, subject to the terms of Section 16(g) below.

(b) In the event that the Claims are not settled by the procedure set forth in Section 16(a), the Claims shall be submitted to arbitration conducted in accordance with the Commercial Arbitration Rules ("Rules") of the American Arbitration Association ("AAA") except as amplified or otherwise varied hereby.

(c) The parties shall submit the dispute to the Milwaukee, Wisconsin regional office of the AAA and the situs of the arbitration shall be Milwaukee, Wisconsin.

(d) The arbitration shall be conducted by a single arbitrator. The parties shall appoint the single arbitrator to arbitrate the dispute within ten (10) business days of the submission of the dispute. In the absence of agreement as to the identity of the single arbitrator to arbitrate the dispute within such time, the AAA is authorized to appoint an arbitrator in accordance with the rules, except that the arbitrator shall have as his principal place of business the Milwaukee, Wisconsin metropolitan area.

(e) The single arbitrator selected by AAA shall be an attorney licensed to practice by the State of Wisconsin.

(f) Anything in the Rules to the contrary notwithstanding, the arbitration award shall be made in accordance with the following procedure: (i) in the event the dispute involves monetary relief, each party shall, at the commencement of the arbitration hearing, submit an initial statement of the amount each party proposes be selected by the arbitrator as the arbitration award ("Settlement Amount"). During the course of the arbitration, each party may vary its proposed Settlement Amount. At the end of the arbitration hearing, each party shall submit to the arbitrator its final Settlement Amount ("Final Settlement Amount"), and the arbitrator shall be required to select either one or the other Final Settlement Amounts as the arbitration award without discretion to select any other amount as the award. The arbitration award shall be paid within thirty (30) business days after the award has been made, together with interest from the date of award at the rate of three percent (3%) per annum. Judgment upon the award may be entered in any federal or state court having jurisdiction over the parties; (ii) in the event the dispute involves the interpretation of this Agreement, each party shall submit an initial statement of the interpretation each party proposes be selected by the arbitrator as the arbitration award ("Proposed Interpretation"). During the course of the arbitration, each party may vary its Proposed Interpretation. At the end of the arbitration hearing, each party shall submit to the arbitrator its final Proposed Interpretation, and the arbitrator shall select either one or the other final Proposed Interpretations, or a reasonable alternative, as the arbitration award. Judgment upon the award may be entered in any federal or state court having jurisdiction over the parties

(g) Notwithstanding anything to the contrary contained herein, any matter which pursuant to the terms of this Agreement is to be resolved by the Board of Merge or the Executive Committee of the Board of Merge in its sole discretion shall be so resolved without arbitration.

### 17. General Provisions.

(a) Goodwill. The Merge Companies and RIS Logic have invested substantial time and money in the development of its products, services, territories, advertising and marketing thereof, soliciting clients

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and creating goodwill. By accepting employment with the Merge Companies, the Executive acknowledges that the customers are the customers of the Merge Companies, and that any goodwill created by the Executive belongs to and shall inure to the benefit of the Merge Companies.

(b) Notices. Any notice required or permitted hereunder shall be made in writing (i) either by actual delivery of the notice into the hands of the party thereunder entitled, or (ii) by depositing the notice with a nationally recognized overnight delivery service, all shipping costs prepaid and addressed to the party to whom the notice is to be given at the party's respective address set forth below, or such other address as the parties may from time to time designate by written notice as herein provided.

If addressed to the Merge Companies:

Merge Technologies Incorporated  
1126 South 70th Street  
Milwaukee, Wisconsin 53214-3151  
Attention: Chief Executive Officer

With a copy to:

Shefsky & Froelich Ltd.  
444 North Michigan Avenue  
Suite 2500  
Chicago, Illinois 60611  
Attention: Mitchell D. Goldsmith, Esq.

If addressed to the Executive:  
Daniel H. Quigg

The notice shall be deemed to be received on the date of its actual receipt by the party entitled thereto in the case of personal delivery and one day following mailing in the case of (ii) above.

(c) Amendment and Waiver. No amendment or modification of this Agreement shall be valid or binding upon the Merge Companies unless made in writing and signed by officers of the Merge Companies duly authorized by the Board or upon the Executive unless made in writing and signed by him. The waiver by the Merge Companies of the breach of any provision of this Agreement by the Executive shall not operate or be construed as a waiver of any subsequent breach by him.

(d) Entire Agreement. This Agreement constitutes the entire Agreement between the parties with respect to the Executive's duties and compensation as an executive of the Merge Companies, and there are no representations, warranties, agreements or commitments between the parties hereto with respect to his employment except as set forth herein. No presumption shall be made in favor or against either party based upon who has served as draftsman of this Agreement.

(e) Governing Law. This Agreement shall be governed by and construed in accordance with the internal laws (and not the law of conflicts) of the State of Wisconsin.

(f) Severability. If any provision of this Agreement shall, for any reason, be held unenforceable, such provision shall be severed from this Agreement unless, as a result of such severance, the Agreement fails to reflect

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the basic intent of the parties. If the Agreement continues to reflect the basic intent of the parties, then the invalidity of such specific provision shall not affect the enforceability of any other provision herein, and the remaining provisions shall remain in full force and effect.

(g) Assignment. The Executive may not under any circumstances delegate any of his rights and obligations hereunder without first obtaining the prior written consent of Merge. This Agreement and all of the Merge's Companies rights and obligations hereunder may be assigned or transferred by them, in whole or in part, to be binding upon and inure to the benefit of any acquirer of Operating Sub or successor of Operating Sub.

(h) Costs of Enforcement, Litigation. In the event of any suit or proceeding seeking to enforce the terms, covenants, or conditions of this Agreement, the prevailing party shall, in addition to all other remedies and relief that may be available under this Agreement or applicable law, recover his or its reasonable attorneys' fees and costs as shall be determined and awarded by the court. Notwithstanding anything to the contrary contained in Section 16 above or elsewhere herein any controversy or dispute with respect to the terms of Section 11, 13, 14, or 15 of this Agreement will survive termination of this Agreement and shall be litigated in the state of federal courts of competent jurisdiction situated in Milwaukee, Wisconsin, to which jurisdiction and venue all parties consent.

(i) Mitigation. The Executive shall be obligated to mitigate his damages as a result of voluntary or involuntary termination of employment with the Merge.

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IN WITNESS WHEREOF, this Agreement is entered into as of the day and year first above written.

MERGE TECHNOLOGIES INCORPORATED

RISLOGIC, INC.

By: /s/ Richard A. Linden

By: /s/ Richard A. Linden

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Richard A. Linden  
President and Chief Executive Officer

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Authorized Officer

EXECUTIVE:

/s/ Daniel H. Quigg

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Daniel H. Quigg