

VITAL IMAGES INC
Form 10-Q
May 12, 2008

**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 March 31, 2008

OR

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

For the transition period from to

Commission File Number 0-22229

VITAL IMAGES, INC.

(Exact name of registrant as specified in its charter)

Minnesota
(State or other jurisdiction of

42-1321776
(I.R.S. Employer Identification No.)

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incorporation or organization)

5850 Opus Parkway, Suite 300
Minnetonka, Minnesota
(Address of principal
executive offices)

55343-4414
(Zip Code)

(952) 487-9500

(Registrant's telephone number, including area code)

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

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

Large accelerated filer

Accelerated filer

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

Smaller reporting company

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

Yes No

On May 5, 2008, there were 17,203,652 shares of the Registrant's common stock, par value \$.01 per share, outstanding.

Vital Images, Inc.
Form 10-Q
March 31, 2008

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Part I. Financial Information

Item 1. Financial Statements

Vital Images, Inc.
Condensed Consolidated Balance Sheets

(In thousands, except per share amounts)
(Unaudited)

| | March 31, 2008 | December 31, 2007 |
|--|-------------------|----------------------|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 144,058 | \$ 146,685 |
| Marketable securities | 31,280 | 31,709 |
| Accounts receivable, net | 16,266 | 15,962 |
| Deferred income taxes | 3,472 | 3,472 |
| Prepaid expenses and other current assets | 2,436 | 2,441 |
| Total current assets | 197,512 | 200,269 |
| Marketable securities | 3,578 | |
| Property and equipment, net | 10,909 | 11,165 |
| Deferred income taxes | 8,924 | 8,621 |
| Other intangible assets, net | 1,591 | 1,852 |
| Goodwill | 9,089 | 9,089 |
| Total assets | \$ 231,603 | \$ 230,996 |
| Liabilities and Stockholders Equity | | |
| Current liabilities: | | |
| Accounts payable | \$ 2,579 | \$ 3,330 |
| Accrued compensation | 3,052 | 3,092 |
| Accrued royalties | 1,150 | 1,113 |
| Other current liabilities | 2,487 | 2,282 |
| Deferred revenue | 16,825 | 16,547 |
| Total current liabilities | 26,093 | 26,364 |
| Deferred revenue | 1,250 | 1,140 |
| Deferred rent | 1,178 | 1,276 |
| Total liabilities | 28,521 | 28,780 |
| Commitments and contingencies (Note 9) | | |
| Stockholders equity: | | |
| Preferred stock: \$0.01 par value; 5,000 shares authorized; none issued or outstanding | | |
| Common stock: \$0.01 par value; 40,000 shares authorized; 17,177 issued and outstanding as of March 31, 2008; and 17,153 shares issued and outstanding as of December 31, 2007 | 172 | 172 |
| Additional paid-in capital | 201,054 | 199,625 |
| Retained earnings | 1,826 | 2,420 |
| Accumulated other comprehensive income (loss) | 30 | (1) |
| Total stockholders equity | 203,082 | 202,216 |
| Total liabilities and stockholders equity | \$ 231,603 | \$ 230,996 |

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

Vital Images, Inc.

Condensed Consolidated Statements of Operations

(In thousands, except per share amounts)
(Unaudited)

| | For the three months ended | |
|--|----------------------------|-----------|
| | 2008 | 2007 |
| March 31, | | |
| Revenue: | | |
| License fees | \$ 9,358 | \$ 13,470 |
| Maintenance and services | 7,534 | 7,049 |
| Hardware | 425 | 306 |
| Total revenue | 17,317 | 20,825 |
| Cost of revenue: | | |
| License fees | 1,153 | 1,605 |
| Maintenance and services | 2,572 | 2,523 |
| Hardware | 195 | 217 |
| Total cost of revenue | 3,920 | 4,345 |
| Gross profit | 13,397 | 16,480 |
| Operating expenses: | | |
| Sales and marketing | 8,051 | 8,025 |
| Research and development | 4,285 | 3,541 |
| General and administrative | 3,651 | 3,512 |
| Total operating expenses | 15,987 | 15,078 |
| Operating (loss) income | (2,590) | 1,402 |
| Interest income | 1,685 | 2,144 |
| (Loss) income before income taxes | (905) | 3,546 |
| (Benefit) provision for income taxes | (311) | 1,174 |
| Net (loss) income | \$ (594) | \$ 2,372 |
| Net (loss) income per share basic | \$ (0.03) | \$ 0.14 |
| Net (loss) income per share diluted | \$ (0.03) | \$ 0.14 |
| Weighted average common shares outstanding - basic | 17,075 | 16,845 |
| Weighted average common shares outstanding - diluted | 17,075 | 17,533 |

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

Vital Images, Inc.
Condensed Consolidated Statements of Cash Flows

(In thousands)
(Unaudited)

| | For the three months ended March 31, | |
|--|---|------------|
| | 2008 | 2007 |
| Cash flows from operating activities: | | |
| Net (loss) income | \$ (594) | \$ 2,372 |
| Adjustments to reconcile net (loss) income to net cash provided by operating activities: | | |
| Depreciation and amortization of property and equipment | 1,244 | 1,026 |
| Amortization of identified intangibles | 261 | 326 |
| Provision for doubtful accounts | 135 | 53 |
| Deferred income taxes | (311) | 1,174 |
| Excess tax benefit from stock transactions | (66) | (958) |
| Amortization of discount and accretion of premium on marketable securities | (299) | (153) |
| Employee stock-based compensation | 1,232 | 1,275 |
| Amortization of deferred rent | (93) | (70) |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (439) | (942) |
| Prepaid expenses and other assets | 5 | (144) |
| Accounts payable | (439) | (915) |
| Accrued expenses and other liabilities | 65 | (1,292) |
| Deferred revenue | 388 | 876 |
| Deferred rent | | 199 |
| Net cash provided by operating activities | 1,089 | 2,827 |
| Cash flows from investing activities: | | |
| Purchases of property and equipment | (1,300) | (1,937) |
| Purchases of marketable securities | (20,609) | (9,764) |
| Proceeds from maturities of marketable securities | 16,227 | 10,950 |
| Proceeds from sale of marketable securities | 1,581 | |
| Net cash used in investing activities | (4,101) | (751) |
| Cash flows from financing activities: | | |
| Proceeds from sale of common stock under stock plans | 319 | 1,292 |
| Excess tax benefit from stock transactions | 66 | 958 |
| Net cash provided by financing activities | 385 | 2,250 |
| Net (decrease) increase in cash and cash equivalents | (2,627) | 4,326 |
| Cash and cash equivalents, beginning of period | 146,685 | 144,382 |
| Cash and cash equivalents, end of period | \$ 144,058 | \$ 148,708 |

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

Vital Images, Inc.

Notes to Condensed Consolidated Financial Statements (Unaudited)

1. Basis of presentation

The accompanying unaudited Condensed Consolidated Financial Statements of Vital Images, Inc. (the Company) have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and notes required by accounting principles generally accepted in the United States of America. In the opinion of management, all adjustments, consisting only of normal recurring adjustments, for a fair statement have been included. Operating results for the three months ended March 31, 2008 are not necessarily indicative of the results that may be expected for any subsequent quarter or for the year ending December 31, 2008. The December 31, 2007 condensed consolidated balance sheet information was derived from audited financial statements but does not include all disclosures required by accounting principles generally accepted in the United States of America. These financial statements should be read in conjunction with the financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2007.

The Condensed Consolidated Financial Statements include the accounts of the Company and its wholly-owned subsidiaries. All intercompany accounts and transactions have been eliminated. The Company views its operations and manages its business as one reportable segment—the development and marketing of software and related services for enterprise-wide advanced visualization and analysis solutions for use by medical professionals in clinical analysis and therapy planning. Factors used to identify the Company's single operating segment include the financial information available for evaluation by the chief operating decision maker in making decisions about how to allocate resources and assess performance. The Company markets its products and services through a direct sales force and independent distributors in the United States and international markets.

2. Major customer and geographic data

Major customers (dollars in thousands):

| | For the three months ended | | | | |
|-------------------------------------|----------------------------|-------|-----------|-------|------|
| | 2008 | | March 31, | | 2007 |
| Toshiba Medical Systems Corporation | \$ | 8,782 | \$ | 9,937 | |
| Percentage of total revenue | | 51% | | 48% | |
| McKesson Information Systems LLC | \$ | 1,590 | \$ | 1,737 | |
| Percentage of total revenue | | 9% | | 8% | |

As of March 31, 2008 and December 31, 2007, Toshiba Medical Systems Corporation accounted for 53% and 34% of accounts receivable, respectively. As of March 31, 2008 and December 31, 2007, McKesson Information Systems LLC accounted for 9% and 6% of accounts receivable, respectively.

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

| | For the three months ended | | | |
|--|----------------------------|-----------|-----------|------|
| | March 31, | | March 31, | |
| | 2008 | 2007 | 2008 | 2007 |
| United States | \$ 13,224 | \$ 16,834 | | |
| Europe | 2,039 | 2,643 | | |
| Asia and Pacific Region | 887 | 719 | | |
| Canada | 728 | 55 | | |
| Other Foreign Countries | 439 | 574 | | |
| Totals | \$ 17,317 | \$ 20,825 | | |
| Export revenue as a percent of total revenue | 24% | 19% | | |

Substantially all of the Company's export sales are negotiated, invoiced and paid in U.S. dollars.

3. Equity-based compensation

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

| | For the three months ended | | | |
|---|----------------------------|----------|-----------|------|
| | March 31, | | March 31, | |
| | 2008 | 2007 | 2008 | 2007 |
| Cost of revenue | \$ 76 | \$ 97 | | |
| Sales and marketing | 368 | 529 | | |
| Research and development | 265 | 137 | | |
| General and administrative | 523 | 513 | | |
| Total equity-based compensation expense | \$ 1,232 | \$ 1,276 | | |

As of March 31, 2008, approximately \$11.2 million of unrecognized compensation expense related to stock options was expected to be recognized over a weighted-average period of 3.1 years. As of March 31, 2008, approximately \$1.0 million of unrecognized compensation expense related to restricted stock awards was expected to be recognized over a weighted-average period of 1.4 years.

The fair value of each option award is estimated on the date of grant using the Black-Scholes option valuation model. The Black-Scholes option valuation model requires the development of assumptions that are input into the model. These assumptions are the expected stock volatility, the risk-free interest rate, the option's expected life and the dividend yield on the underlying stock.

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For purposes of calculating the fair value of options under Statement of Accounting Standard (SFAS) No. 123(R), Share-Based Payment, the weighted-average fair value of options granted was \$5.67 and \$13.94 for the three months ended March 31, 2008 and 2007, respectively. The weighted-average fair values for the options were based on the fair values on the dates of grant. The fair values for the options were calculated using the Black-Scholes option-pricing model, with the following weighted-average assumptions and expense adjusted using the following expected forfeiture rate assumptions:

| | For the three months ended March 31, | |
|----------------------------|---|------------|
| | 2008 | 2007 |
| Expected option life | 3.75 years | 3.75 years |
| Expected volatility factor | 46% | 52% |
| Expected dividend yield | 0% | 0% |
| Risk-free interest rate | 2.35% | 4.49% |
| Expected forfeiture rate | 1.06% | 1.07% |

The following table summarizes stock option activity for the three months ended March 31, 2008:

| | Shares Underlying Options |
|---|------------------------------|
| Total outstanding as of December 31, 2007 | 1,981,404 |
| Options granted | 689,120 |
| Options exercised | (24,040) |
| Options cancelled | (25,256) |
| Total outstanding as of March 31, 2008 | 2,621,228 |

Options granted during the three months ended March 31, 2008 primarily consisted of the Company's annual grant to employees.

In the first quarter of 2007, the Company granted shares of restricted stock with performance-based vesting to certain employees. No equity-based compensation expense for the awards was recognized for the three months ended March 31, 2008, as the Company did not consider achievement of the performance metrics to be probable. The cumulative amount of the expense related to the awards not recognized as of March 31, 2008 but which may be recognized in future periods if performance metrics are met was \$124,000.

4. Per share data

Basic net income (loss) per share is computed using net income (loss) and the weighted-average number of common shares outstanding. Diluted net income (loss) per share reflects the weighted-average number of common shares outstanding plus any potentially dilutive shares outstanding during the period. Potentially dilutive shares consist of shares issuable upon the exercise of stock options, as well as unvested restricted stock. For the 2008 first quarter, all common share equivalents were anti-dilutive because the Company generated a net loss. For the 2007 first quarter, options and restricted stock awards for 736,000 shares were excluded from the computation of diluted earnings per share because their effect would have been anti-dilutive.

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The computations for basic and diluted net (loss) income per share are as follows (in thousands, except per share amounts):

| | For the three months ended | |
|--|----------------------------|----------|
| | March 31, | |
| | 2008 | 2007 |
| Numerator: | | |
| Net (loss) income | \$ (594) | \$ 2,372 |
| Denominator: | | |
| Denominator for weighted average common shares outstanding - basic | 17,075 | 16,845 |
| Dilution associated with the Company's stock-based compensation plans | | 688 |
| Denominator for weighted average common shares outstanding - diluted | 17,075 | 17,533 |
| Net (loss) income per share - basic | \$ (0.03) | \$ 0.14 |
| Net (loss) income per share - diluted | \$ (0.03) | \$ 0.14 |
| Antidilutive stock options and restricted stock awards excluded from above calculation | 2,687 | 736 |

5. Comprehensive (loss) income

Comprehensive (loss) income as defined by SFAS No. 130, Reporting Comprehensive Income (SFAS 130), includes net (loss) income and items defined as other comprehensive income. SFAS 130 requires that items defined as other comprehensive (loss) income, such as unrealized gains and losses on certain marketable securities, be separately classified in the financial statements. Such items are reported in the consolidated statements of stockholders' equity as comprehensive (loss) income.

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

| | For the three months ended | |
|---|----------------------------|----------|
| | March 31, | |
| | 2008 | 2007 |
| Net (loss) income | \$ (594) | \$ 2,372 |
| Other comprehensive income (loss): | | |
| Net change in unrealized gain or loss on available-for-sale investments, net of tax | 31 | (4) |
| Cumulative translation adjustment | | 1 |
| Comprehensive (loss) income | \$ (563) | \$ 2,369 |

6. Other intangible assets

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

| | March 31, 2008 | | | December 31, 2007 | | |
|---|----------------------|--------------------------|--------------------|----------------------|--------------------------|--------------------|
| | Gross Carrying Value | Accumulated Amortization | Net Carrying Value | Gross Carrying Value | Accumulated Amortization | Net Carrying Value |
| Existing software technology | \$ 3,400 | \$ (2,821) | \$ 579 | \$ 3,400 | \$ (2,650) | \$ 750 |
| Patents and patent applications | 2,500 | (1,488) | 1,012 | 2,500 | (1,398) | 1,102 |
| Total intangible assets subject to amortization | \$ 5,900 | \$ (4,309) | \$ 1,591 | \$ 5,900 | \$ (4,048) | \$ 1,852 |

Intangible assets subject to amortization are amortized on a straight-line basis over the estimated period of benefit. Amortization expense related to other intangible assets was \$261,000 and \$296,000 for the three months ended March 31, 2008 and 2007, respectively. The estimated future amortization expense for identified intangible assets as of March 31, 2008 is as follows (in thousands):

| | |
|-------------------|----------|
| Remainder of 2008 | \$ 783 |
| 2009 | 426 |
| 2010 | 360 |
| 2011 | 22 |
| | \$ 1,591 |

The preceding expected amortization expense is an estimate. Actual amortization expense may differ from estimates due to additional intangible asset acquisitions, impairment of intangible assets, accelerated amortization of intangible assets and other events. A patent acquired in the HInnovation, Inc. acquisition having a net book value of \$810,000 as of March 31, 2008 is currently under review by the United States Patent and Trademark Office.

7. Deferred revenue

The components of deferred revenue were as follows:

| | March 31, 2008 | December 31, 2007 |
|-------------------------|----------------|-------------------|
| Maintenance and support | \$ 12,592 | \$ 12,376 |
| Customer education | 3,284 | 3,311 |
| Installation | 670 | 762 |
| Professional services | 242 | 186 |
| Software | 917 | 755 |
| Hardware and other | 370 | 297 |
| Total deferred revenue | 18,075 | 17,687 |
| Less current portion | (16,825) | (16,547) |

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| | | | | |
|---------------------------------------|----|-------|----|-------|
| Long-term portion of deferred revenue | \$ | 1,250 | \$ | 1,140 |
|---------------------------------------|----|-------|----|-------|

8. Income taxes

Under the provisions of Financial Accounting Standards Board (FASB) Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48), the Company did not have any material unrecognized tax benefits as of as of March 31, 2008 and December 31, 2007. The Company recorded no interest and penalties during the three months ended March 31, 2008 and 2007 and had no accrued interest and penalties as of March 31, 2008 and December 31, 2007. The Company is no longer subject to U.S. federal tax examinations by tax authorities for tax years before 2003. The Company is open to state tax audits until the applicable statute of limitations expires. The Company does not expect that the total amount of unrecognized tax benefits as of March 31, 2008 will change materially in the next 12 months.

The Company s consolidated effective income tax rate was 34.3% and 33.1% for the three months ended March 31, 2008 and 2007, respectively, and 20.4% for fiscal year 2007. The provision for income taxes consists of provisions for federal, state and foreign income taxes. The consolidated income tax rate is a composite rate of the applicable rates in the various jurisdictions. The increase in the estimated effective tax rate is primarily due to the expiration of the research and development tax credit on December 31, 2007. The Company does not know if a similar tax credit will be enacted for 2008.

The Company has \$12.4 million of deferred tax assets as of March 31, 2008. The ability to realize these deferred tax assets involves estimates of future taxable income, the estimated impact of future tax deductions from the exercise of stock options outstanding as of each balance sheet date, and the expiration dates and amounts of net operating loss carryforwards and other tax credits. If the Company decreases its estimates of future taxable income or tax deductions from the exercise of stock options, or its stock price increases significantly without an increase in taxable income, causing management to believe that the Company s deferred tax assets may not be utilizable, the Company may need to establish additional valuation allowances on its deferred tax assets, which would reduce or eliminate the Company s ability to use its deferred tax assets to offset taxes due and could materially impact the Company s financial position and results of operations.

After giving consideration to these factors, the Company determined that there was no need to adjust its valuation allowance for deferred tax assets. The Company had a valuation allowance of \$139,000 as of March 31, 2008 and December 31, 2007 relating to net operating losses and tax credits that expire prior to 2010.

9. Commitments and contingencies

Under general contract terms, the Company often includes provisions in its software license agreements under which the Company agrees to indemnify its customers against liability and damages arising from claims of patent, copyright, trademark or trade secret infringement by the Company s software. The Company has not incurred any material costs as a result of this type of indemnification clause, and the Company does not maintain a product warranty liability related to such indemnification clauses.

The Company has entered into various employment agreements with certain executives of the Company, which include provisions for severance payments subject to certain conditions and events.

The Company is involved in various claims and legal actions in the normal course of business. Management is of the opinion that the outcome of such legal actions will not have a significant adverse effect on the Company s financial position, results of operations or cash flows.

Notwithstanding management's belief, an unfavorable resolution of some or all of these matters could materially affect our future results of operations or cash flows.

10. Fair Value Measurements

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements, (SFAS 157), which is effective for fiscal years beginning after November 15, 2007 and for interim periods within those years. This statement defines fair value, establishes a framework for measuring fair value and expands the related disclosure requirements. This statement applies under other accounting pronouncements that require or permit fair value measurements. The statement indicates, among other things, that a fair value measurement assumes that the

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transaction to sell an asset or transfer a liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. SFAS 157 defines fair value based upon an exit price model.

Relative to SFAS 157, the FASB issued FASB Staff Positions (FSP) 157-1 and 157-2. FSP 157-1 amends SFAS 157 to exclude SFAS No. 13, Accounting for Leases, and its related interpretive accounting pronouncements that address leasing transactions, while FSP 157-2 delays the effective date of the application of SFAS 157 to fiscal years beginning after November 15, 2008 for all nonfinancial assets and nonfinancial liabilities that are recognized or disclosed at fair value in the financial statements on a non-recurring basis.

The Company adopted SFAS 157 as of January 1, 2008, with the exception of the application of SFAS 157 to non-recurring nonfinancial assets and nonfinancial liabilities. Non-recurring nonfinancial assets and nonfinancial liabilities to which we have not applied the provisions of SFAS 157 include those measured at fair value during impairment testing for goodwill and other long-lived assets and those initially measured at fair value in a business combination.

SFAS 157 establishes a valuation hierarchy for disclosure of the inputs to valuation used to measure fair value. This hierarchy prioritizes the inputs into three broad levels. Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities. Level 2 inputs are quoted prices for similar assets and liabilities in active markets or inputs that are observable for the asset or liability, either directly or indirectly through market corroboration, for substantially the full term of the financial instrument. Level 3 inputs are unobservable inputs based on our own assumptions used to measure assets and liabilities at fair value. A financial asset's or liability's classification within the hierarchy is determined based on the lowest level input that is significant to the fair value measurement.

The following table provides the assets and liabilities carried at fair value measured on a recurring basis as of March 31, 2008 (in thousands):

| | Fair Value Measurements at March 31, 2008 Using | | | |
|-------------------------------|---|--|---|--|
| | Total Carrying Value at March 31, 2008 | Quoted price in active markets (Level 1) | Significant other observable inputs (Level 2) | Significant unobservable inputs (Level 3) |
| Cash equivalents: | | | | |
| Corporate debt | \$ 126,077 | \$ 126,077 | \$ | \$ |
| Government debt | 14,476 | 14,476 | | |
| | 140,553 | 140,553 | | |
| Marketable securities: | | | | |
| Corporate debt | \$ 16,826 | \$ 15,553 | \$ 1,273 | \$ |
| Government debt | 18,032 | 18,032 | | |
| | 34,858 | 33,585 | 1,273 | |
| | \$ 175,411 | \$ 174,138 | \$ 1,273 | \$ |

Cash equivalents and marketable securities measured at fair value using quoted market prices are classified within Level 1 of the valuation hierarchy. Marketable securities classified within Level 2 of the valuation hierarchy consist of asset-backed securities for which significant observable market data exist but our nonstandard lot sizes prevent measurement using quoted market prices. The valuation of asset-backed securities is determined by reviewing quoted market prices for traded lots of the same or similar securities. All asset-backed securities held by the Company are rated AAA and are current on scheduled pay-downs with expected full maturity within the next 12 months. Given the current conditions of the credit markets, there is some risk the unrealized losses as of March 31, 2008 could increase if the credit markets continue to deteriorate.

The Company analyzes its investments for impairment on an ongoing basis. Factors considered in determining whether an unrealized loss is a temporary loss or an other-than-temporary loss include the length of time and extent to which the securities have been in an unrealized loss position and the Company's ability and intent to hold the investment for a period of time sufficient to allow for any anticipated market recovery. The Company has the ability and intent to hold these investments until anticipated recovery of fair value, which may be maturity, and therefore the Company does not consider these investments to be impaired as of March 31, 2008.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (SFAS 159), which permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. The Company adopted SFAS 159 on January 1, 2008 and has elected not to measure any additional financial instruments and other items at fair value.

11. New Accounting Pronouncements

As mentioned in Note 10, FSP 157-2 delayed the effective date of the application of SFAS 157 to fiscal years beginning after November 15, 2008 for all nonfinancial assets and nonfinancial liabilities that are recognized or disclosed at fair value in the financial statements on a non-recurring basis. Non-recurring nonfinancial assets and nonfinancial liabilities for which we have not applied the provisions of SFAS 157 include those measured at fair value during impairment testing for goodwill and other long-lived assets and those initially measured at fair value in a business combination. The Company is currently assessing the impact of SFAS 157 for nonfinancial assets and nonfinancial liabilities on its consolidated financial position, results of operations and cash flows but does not believe it will have a material impact on the Company.

In December 2007, the FASB issued SFAS No. 141(R), *Business Combinations* (SFAS 141(R)), which changes accounting for business acquisitions. SFAS 141(R) will require the acquiring entity in a business combination to recognize all (and only) the assets acquired and liabilities assumed in the transaction and establish the acquisition-date fair value as the measurement objective for all assets acquired and liabilities assumed in a business combination. Certain provisions of this standard will, among other things, impact the determination of acquisition-date fair value of consideration paid in a business combination (including contingent consideration); exclude transaction costs from acquisition accounting; and change accounting practices for acquired contingencies, acquisition-related restructuring costs, in-process research and development, indemnification assets and tax benefits. SFAS 141(R) will be effective for the Company for business combinations occurring after December 31, 2008. The impact on the Company's consolidated financial statements of adopting SFAS 141(R) will depend on the nature, terms and size of business combinations completed after December 31, 2008.

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

Executive summary

Since the second quarter of 2007, financial results for Vital Images, Inc. (also referred to as we, us and our) have been significantly affected by the industry-wide slowdown in the computed tomography, or CT, market and by the broad impact of the Deficit Reduction Act. Results in the first quarter of 2008 were therefore below our 2007 first quarter results as we continue to operate in this challenging market.

- Revenue decreased 17% to \$17.3 million, compared to \$20.8 million for the first quarter of 2007.
- Gross margin decreased to 77%, compared to 79% for the first quarter of 2007.
- Loss before taxes was \$(905,000), compared to income before taxes of \$3.5 million for the first quarter of 2007.
- Net loss was \$(594,000), or \$(0.03) per diluted share, compared to net income of \$2.4 million, or \$0.14 per diluted share, for the 2007 first quarter.

Our cash, cash equivalents and marketable securities position continued to strengthen during the three months ended March 31, 2008. Total cash, cash equivalents and marketable securities were \$178.9 million as of March 31, 2008, compared to \$178.4 million as of December 31, 2007. However, working capital (defined as current assets less current liabilities) decreased to \$171.4 million as of March 31, 2008, compared to \$173.9 million as of December 31, 2007.

Overview

We are a leading provider of enterprise-wide advanced visualization and image analysis solutions for use by medical professionals in clinical analysis and therapy planning for medical conditions. We provide software, customer education, software maintenance, professional services and, on occasion, third-party hardware to our customers. Our technology rapidly transforms complex data generated by diagnostic imaging equipment into functional digital images that can be manipulated and analyzed using our specialized applications to better understand internal anatomy and pathology. Our solutions are designed to improve physician workflow and productivity, enhance the ability to make clinical decisions, facilitate less invasive patient care, and complement often significant capital investments in diagnostic imaging equipment made by our customers. Our software is compatible with equipment from all major manufacturers of diagnostic imaging equipment, such as CT scanners, and can be integrated into picture archiving and communication systems, or PACS. Many hospitals use PACS to acquire, distribute and archive medical images and diagnostic reports, reducing the need for film and increasing reliance on advanced visualization solutions such as ours. We also offer a Web-based solution that provides physicians with anywhere, anytime access to medical images and visualization tools through any

Internet-enabled computer.

We operate and manage our business as a single business segment the development and marketing of software and related services for enterprise-wide advanced visualization and analysis solutions for use by medical professionals in clinical analysis and therapy planning. We market our products and services through a direct sales force, resellers and independent distributors in the United States and in international markets. Our common stock is currently traded on The NASDAQ Global Select Market under the symbol VTAL.

*Vitre*a® software, our flagship software product, is an easy-to-use, intuitive, high-speed volume rendering technology that creates interactive two-dimensional, or 2D, three-dimensional, or 3D, and four-dimensional, or 4D, images from information generated by standard CT scanners. *Vitre*a is commonly deployed on standalone workstations, as well as on PACS, using standard computer hardware, and provides advanced visualization for radiological, cardiac, oncological and surgical applications. *Vitre*a renders vibrant, clear, color images at high speeds and enables users to interactively navigate within these images to visualize, measure and understand internal structures and disease conditions. We believe our user interfaces are intuitive, and they are specifically configured to assist physicians in optimizing their clinical workflow. *Vitre*aACCESS creates *Vitre*a-to-*Vitre*a workflow by allowing a *Vitre*a license and associated software to be used on other *Vitre*a workstations (non-simultaneously). This enables a facility to pass its access to *Vitre*a licenses from one workstation to another, giving the entire facility

flexibility in how and where it uses its *Vitre*a licenses. *Vitre*aACCESS -Remote software provides physicians remote access to the full suite of advanced visualization and analysis tools provided by *Vitre*a software. It offers a cost effective solution designed to enable users to leverage workstations by allowing secure access to *Vitre*a applications from any personal computer in a facility or from external locations through a virtual private network, or VPN.

VITALConnect® software, our Web-based solution, allows multiple physicians to collaboratively use enterprise-wide advanced visualization in their medical practices. It provides radiologists and referring physicians anywhere, anytime access to interactive 2D, 3D and 4D medical images and the ability to measure, rotate, analyze and segment those images. Our latest release includes features previously available only on multimodality workstations, such as a variety of multi-planar reformat, or MPR, modes, thick slab rendering in MPR, 3D volumetric visualization with simple point of interest navigation, 4D dataset visualization, CT/positron emission tomography, or PET, fusion and advanced analysis tools.

We also offer enterprise-wide advanced visualization options that can expand the relevance of our products beyond the radiology department to referring physicians and surgical specialists, particularly in the areas of cardiology, cardiovascular, oncology, neurology and gastroenterology. Our advanced visualization options allow physicians to customize their *Vitre*a software according to their unique requirements. Most options are proprietary; however, *Vitre*a also serves as an integration platform for the applications offered by our visualization technology partners. *Vitre*a's add-on options include:

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

Our software solutions are used with medical diagnostic equipment, primarily in clinical analysis and therapy planning. Our software applies proprietary technologies to a variety of data supplied by CT scanners to allow medical clinicians to create 2D, 3D and 4D views of human anatomy and to non-invasively navigate within these images to better visualize and understand internal structures and pathologies. We market *Vitre*a and *VITALConnect* both as standalone software packages and as part of integrated software and hardware systems to radiologists, cardiologists, surgeons, other specialized physicians, primary care physicians and medical researchers. Our main customers are hospitals and clinics, university medical schools and diagnostic imaging companies. We market our products and services to these customers both directly through our own sales force and indirectly through digital imaging equipment manufacturers and PACS companies, who sell our products with products they either manufacture or acquire from third parties.

Our products work with equipment from all major manufacturers of diagnostic imaging systems, including Toshiba Medical Systems Corporation (Toshiba), GE Medical Systems, Siemens Medical Systems, Inc. and Philips Medical Systems. Our products may also be integrated into PACS, such as those marketed by McKesson Corporation (McKesson), Sectra AB and DR Systems, Inc., and run on off-the-shelf third-party computer hardware.

Critical accounting policies and estimates

Our discussion and analysis of financial condition and results of operations are based upon our Condensed Consolidated Financial Statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. We have adopted various accounting policies to prepare the Condensed Consolidated Financial Statements in accordance with accounting principles generally accepted in the United States of America. The most significant accounting policies are disclosed in Note 2 to the Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended December 31, 2007. The preparation of these financial statements requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates. We continually evaluate our critical accounting policies and estimates. We discuss our critical accounting estimates in Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the fiscal year ended December 31, 2007. The adoption of SFAS No. 157, Fair Value Measurements (SFAS 157) was the only significant change in our critical accounting policies or estimates since December 31, 2007.

Results of Operations

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

| | For the three months ended March 31, | |
|--------------------------------------|---|-------|
| | 2008 | 2007 |
| Revenue: | | |
| License fees | 54.0% | 64.7% |
| Maintenance and services | 43.5 | 33.8 |
| Hardware | 2.5 | 1.5 |
| Total revenue | 100.0 | 100.0 |
| Cost of revenue: | | |
| License fees | 6.6 | 7.7 |
| Maintenance and services | 14.9 | 12.1 |
| Hardware | 1.1 | 1.1 |
| Total cost of revenue | 22.6 | 20.9 |
| Gross profit | 77.4 | 79.1 |
| Operating expenses: | | |
| Sales and marketing | 46.5 | 38.5 |
| Research and development | 24.7 | 17.0 |
| General and administrative | 21.2 | 16.9 |
| Total operating expenses | 92.4 | 72.4 |
| Operating (loss) income | (15.0) | 6.7 |
| Interest income | 9.8 | 10.3 |
| (Loss) income before income taxes | (5.2) | 17.0 |
| (Benefit) provision for income taxes | (1.8) | 5.6 |
| Net (loss) income | (3.4)% | 11.4% |

Revenue (dollars in thousands)

| | For the three months ended March 31, | | | Change |
|--------------------------|---|-----------|------------|--------|
| | 2008 | 2007 | | |
| Revenue: | | | | |
| License fees | \$ 9,358 | \$ 13,470 | \$ (4,112) | (31)% |
| Maintenance and services | 7,534 | 7,049 | 485 | 7% |
| Hardware | 425 | 306 | 119 | 39% |
| Total revenue | \$ 17,317 | \$ 20,825 | \$ (3,508) | (17)% |

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Revenue for the three months ended March 31, 2008 was affected primarily by decreased sales of software licenses primarily due to a slowdown in the CT scanner market, offset by increased maintenance and services revenue from a larger installed base of customers.

License fee revenue (dollars in thousands)

| | For the three months ended | | | |
|--|----------------------------|-----------|------------|-------|
| | March 31, | | | |
| | 2008 | 2007 | Change | |
| License fee revenue: | | | | |
| Vitreia licenses | \$ 3,020 | \$ 4,489 | \$ (1,469) | (33)% |
| Vitreia options and third party software | 5,895 | 8,566 | (2,671) | (31)% |
| Other | 443 | 415 | 28 | 7% |
| Total license fee revenue | \$ 9,358 | \$ 13,470 | \$ (4,112) | (31)% |

The decrease in license fee revenue during the three months ended March 31, 2008 was driven primarily by a decrease in the number of *Vitreia* licenses sold. Top-selling options for the three months ended March 31, 2008 and 2007 were General Vessel Probe, Automated Vessel Measurement and CT Cardiac all cardiovascular solutions. The following table sets forth information on license fee revenue by source:

| | For the three months ended | |
|---------------------------------|----------------------------|------|
| | March 31, | |
| | 2008 | 2007 |
| Percent of license fee revenue: | | |
| Direct | 25% | 36% |
| Toshiba | 66 | 56 |
| McKesson | 9 | 8 |
| Total license fee revenue | 100% | 100% |

Maintenance and services revenue (dollars in thousands)

| | For the three months ended | | | |
|-----------------------------------|----------------------------|----------|----------|-------|
| | March 31, | | | |
| | 2008 | 2007 | Change | |
| Maintenance and services revenue: | | | | |
| Maintenance and support | \$ 6,141 | \$ 5,039 | \$ 1,102 | 22% |
| Customer education | 1,030 | 1,672 | (642) | (38)% |
| Installation | 363 | 338 | 25 | 7% |
| Total maintenance and services | \$ 7,534 | \$ 7,049 | \$ 485 | 7% |

The increase in maintenance and support revenue for the three months ended March 31, 2008, compared to the same period in 2007, was due to a significant increase in the number of customers on maintenance contracts, as well as to increased pricing on maintenance-related services. The decrease in customer education revenue for the three months ended March 31, 2008, compared to the same period in 2007, was due to the general timing of training sessions and the effect of decreased license sales. Installation revenue increased due to the timing of installations and increased installation revenue from *VitalConnect* software for the three months ended March 31, 2008.

Hardware revenue

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Hardware revenue increased 39% to \$425,000 in the first quarter of 2008, compared to \$306,000 in the first quarter of 2007. We offer to sell hardware to our customers in conjunction with license sales, and fluctuations are driven by individual customer purchasing preferences. Sales of hardware systems are not core to our strategy and will fluctuate from period to period depending upon the needs of our customers.

Cost of revenue and gross profit

A comparison of gross profit and gross margin by revenue category is as follows (dollars in thousands):

| | For the three months ended March 31, | | | |
|---------------------------|---|------------------|-------------------|--------------|
| | 2008 | 2007 | Change | |
| Gross profit: | | | | |
| License fees | \$ 8,205 | \$ 11,865 | \$ (3,660) | (31)% |
| Maintenance and services | 4,962 | 4,526 | 436 | 10% |
| Hardware | 230 | 89 | 141 | 158% |
| Total gross profit | \$ 13,397 | \$ 16,480 | \$ (3,083) | (19)% |
| Gross margin: | | | | |
| License fees | 88% | 88% | | |
| Maintenance and services | 66% | 64% | | |
| Hardware | 54% | 29% | | |
| Total gross margin | 77% | 79% | | |

License fee gross margin for the three months ended March 31, 2008 was consistent with the same period in 2007.

Maintenance and services gross margin increased during the three months ended March 31, 2008, compared to the same period in 2007, due to increases in the percentage of our customers who purchase maintenance services, as well as some increases in our pricing, without an increase in costs at a similar rate. We will continue to invest in our customer education, installation, professional services and customer support areas in the future to adequately support our growing installed base of customers. The increase in maintenance and services revenue as a percent of total revenue in the first quarter of 2008 compared to the same period in 2007 resulted in a lower overall gross margin for the 2008 first quarter.

Hardware gross margin increased for the three months ended March 31, 2008, compared to the same period in 2007, due to more favorable pricing in the first quarter of 2008.

Operating expenses

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

| | Percent of revenue for the three months ended March 31, | | Percent increase for the three months ended March 31, 2007 to 2008 |
|----------------------------|--|-------------|---|
| | 2008 | 2007 | |
| Operating expenses: | | | |
| Sales and marketing | 46.5% | 38.5% | % |
| Research and development | 24.7 | 17.0 | 21% |

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| | | | |
|----------------------------|-------|-------|----|
| General and administrative | 21.2 | 16.9 | 4% |
| Total operating expenses | 92.4% | 72.4% | 6% |

Sales and marketing

Sales and marketing expenses remained relatively flat at \$8.1 million in the first quarter of 2008, compared to \$8.0 million in the first quarter of 2007. Changes in sales and marketing expenses are as follows (dollars in thousands):

| | Increase (decrease) from the three months ended March 31, 2007 to 2008 | |
|---------------------------------|---|----------------|
| | Amount | Percent |
| Salaries, benefits and bonuses | \$ 349 | 12% |
| Depreciation | 111 | 36% |
| Overhead and other expenses | 101 | 10% |
| Travel, meals and entertainment | 9 | 1% |
| Trade shows and advertising | (33) | (4)% |
| Equity-based compensation | (161) | (30)% |
| Commissions | (350) | (23)% |
| Total | \$ 26 | % |

The increase in salaries and benefits costs resulted from additional personnel and international expansion. The decrease in equity-based compensation was due to the cancellation of options from terminated employees and to a personnel reorganization in the second quarter of 2007. Commission expense decreased in the first quarter of 2008 due to sales representatives being below plan relative to the 2007 first quarter. During the first quarter of 2008, we restructured the number of our United States sales zones from six to five. We had 101 and 96 sales and marketing personnel as of March 31, 2008 and 2007, respectively.

We will continue to manage sales and marketing expenses based on market conditions and business opportunities. For full year 2008, we expect sales and marketing expenses will be approximately 45% to 48% of total revenue.

Research and development

Research and development expenses increased \$744,000 to \$4.3 million in the first quarter of 2008, compared to \$3.5 million in the first quarter of 2007. The change in research and development expenses is as follows (dollars in thousands):

| | Increase (decrease) from the three months ended March 31, 2007 to 2008 | |
|--------------------------------|---|----------------|
| | Amount | Percent |
| Consulting | \$ 270 | 519% |
| Salaries, benefits and bonuses | 228 | 9% |
| Overhead and other expenses | 134 | 21% |
| Equity-based compensation | 127 | 93% |
| Depreciation | (15) | (6)% |
| Total | \$ 744 | 21% |

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The increase in research and development expenses for the three months ended March 31, 2008 was primarily due to an increase in consulting expense and compensation costs as a result of additional consultants and personnel focused on product development. We had 116 and 99 research and development personnel as of March 31, 2008 and 2007, respectively.

We will continue to devote resources to develop applications focused on cardiovascular disease and oncology, PACS integration and Web-based solutions that help physicians across the hospital enterprise better serve their patients. For full year 2008, we expect research and development expenses will be approximately 24% to 26% of total revenue.

General and administrative

General and administrative expenses increased \$139,000 to \$3.7 million in the first quarter of 2008, compared to \$3.5 million in the first quarter of 2007. The change in general and administrative expenses is as follows (dollars in thousands):

| | Increase (decrease) from the three months ended March 31, 2007 to 2008 | |
|-------------------------------------|--|---------|
| | Amount | Percent |
| Overhead and other expenses | \$ 166 | 23% |
| Consulting | 103 | 37% |
| Accounting, auditing and legal fees | 30 | 6% |
| Equity-based compensation | 10 | 2% |
| Salaries, benefits and bonuses | (170) | (12)% |
| Total | \$ 139 | 4% |

The increase in general and administrative expenses during the three months ended March 31, 2008, compared to the same period in 2007, was primarily due to increases in consulting and overhead expenses we began to incur in the second half of 2007 related to international expansion. The decrease in salaries, benefits and bonuses was primarily the result of a decrease in bonus expense due to lower company performance against the bonus plan in the first quarter of 2008. We had 54 and 52 general and administrative personnel as of March 31, 2008 and 2007, respectively. We expect general and administrative expenses to decrease moderately in future periods as we continue to manage costs. For full year 2008, we expect research and development expenses will be approximately 18% to 20% of total revenue.

Equity-based compensation

Equity-based compensation decreased \$44,000 to \$1.2 million for the three months ended March 31, 2008, compared to \$1.3 million in the same quarter in 2007.

Interest income

We generated \$1.7 million of interest income in the first quarter of 2008, compared to \$2.1 million in the first quarter of 2007. The decrease for the three months ended March 31, 2008, compared to the same period in 2007, was primarily due to a decline in interest rates.

Income taxes

Our consolidated effective income tax rate was 34.3% and 33.1% for the three months ended March 31, 2008 and 2007, respectively, and 20.4% for fiscal year 2007. The provision for income taxes consists of provisions for federal, state and foreign income taxes. The consolidated income tax rate is a composite rate of applicable rates in the various jurisdictions. The increase in the estimated effective tax rate is primarily due to the

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expiration of the research and development credit on December 31, 2007. We do not know if a similar tax credit will be enacted for 2008.

Due to the utilization of deferred tax assets relating to net operating losses and tax deductions from the exercise of stock options, we do not anticipate paying any significant federal income taxes for the next two to three years. Actual results could accelerate or defer the utilization of our deferred tax assets. Additionally, if we are unable to generate sufficient taxable income, causing us to believe that our deferred tax assets will not be utilizable, additional valuation allowances may need to be established on our deferred tax assets, which would reduce or eliminate our ability to use our deferred tax assets to offset taxes due and could materially impact our financial position and results of operations.

Liquidity and capital resources

As of March 31, 2008, we had \$178.9 million in cash, cash equivalents and marketable securities, working capital (defined as current assets less current liabilities) of \$171.4 million and no borrowings, as compared to \$178.4 million in cash, cash equivalents and marketable securities, working capital of \$173.9 million and no borrowings as of December 31, 2007.

Operating activities

During the first three months of 2008, cash provided by operations was \$1.1 million, which consisted of a net loss of \$594,000, an increase of \$2.1 million from other non-cash operating activities, primarily equity-based compensation and depreciation, and a decrease of \$420,000 from changes in working capital accounts. Changes in working capital accounts primarily related to an increase in accounts receivable of \$439,000 due to timing of customer payments and a decrease in accounts payable of \$439,000 due to the general timing of payments to vendors. Days sales outstanding (calculated by dividing ending net accounts receivable by revenue per day) were 84 and 83 as of March 31, 2008 and December 31, 2007, respectively. Our aging remains relatively current, with less than 10% of receivables greater than 90 days past due as of March 31, 2008 and December 31, 2007. We use days sales outstanding as an activity measure which places emphasis and focus on accounts receivable, but this measure is not defined under U.S. generally accepted accounting principles, and similarly titled measures may not be computed in the same way by other companies. The decreases in cash were offset by increases in deferred revenue of \$388,000, accrued expenses and other liabilities of \$65,000 and an increase in prepaid expenses of \$5,000.

During the first three months of 2007, cash provided by operations was \$2.8 million, which consisted of net income of \$2.4 million, a decrease of \$2.4 million from changes in working capital accounts, an increase of \$199,000 in deferred rent relating to payments made by our Minnetonka landlord for our benefit, and an increase of \$2.6 million from other non-cash operating activities. Changes in working capital accounts primarily related to a decrease in accrued expenses and other liabilities of \$1.3 million, a decrease in accounts payable of \$915,000, an increase in accounts receivable of \$942,000, and an increase in deferred revenue of \$876,000. Days sales outstanding were 90 and 101 as of March 31, 2007 and December 31, 2006, respectively. Our aging was relatively current, with less than 10% of receivables greater than 90 days past due as of March 31, 2007 and December 31, 2006.

Investing activities

Net cash used in investing activities was \$4.1 million during the first three months of 2008. Net cash used by investing activities was \$751,000 during the first three months of 2007.

We used \$1.3 million for purchases of property and equipment during the three months ended March 31, 2008, compared to \$1.9 million for the same period in 2007. The purchases for the first three months of 2008 were primarily related to our continued implementation of an enterprise resource planning system. The purchases for the first three months of 2007 were principally to expand our facilities, upgrade computer equipment and purchase computer equipment for new personnel. We anticipate that we will continue to purchase property and equipment in the normal course of business. The amount and timing of these purchases and the related cash outflows in future periods are difficult to predict and depend on a number of factors, including the hiring of employees and the rate of change of computer hardware.

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We used \$20.6 million to purchase investments in marketable securities during the first three months of 2008, compared to \$9.8 million for the same period in 2007. We realized \$17.8 million of proceeds from maturities and sales of marketable securities during the first three months of 2008, compared to \$11.0 million for the same period in 2007. As of March 31, 2008, our marketable securities consisted of U.S. government obligations, U.S. government agency obligations, corporate commercial obligations and certificates of deposit.

Financing activities

Cash provided by financing activities totaled \$385,000 and \$2.3 million for the first three months of 2008 and 2007, respectively. Proceeds from the sale of common stock under stock plans were \$319,000 and \$1.3 million during the first three months of 2008 and 2007, respectively. The remaining increase in the first three months of 2008 and 2007 related to the excess tax benefit from stock transactions.

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

Off-balance-sheet arrangements

We did not have any off-balance sheet arrangements as of March 31, 2008 or December 31, 2007.

Other purchase commitments

We had no significant outstanding purchase orders as of March 31, 2008. We have entered into a number of technology licensing agreements that provide for the payment of royalties when we sell *Vitreva* and *ViTALConnect*; we are not obligated for any minimum payments under such agreements.

Foreign currency transactions

Substantially all of our foreign transactions are negotiated, invoiced and paid in U.S. dollars.

Inflation

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

Recent accounting pronouncements

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In February 2008, the Financial Accounting Standards Board (FASB) issued FASB Staff Position No. 157-2, which delayed the effective date of the application of Statement of Accounting Standard (SFAS) No. 157 (SFAS 157) to fiscal years beginning after November 15, 2008 for all nonfinancial assets and nonfinancial liabilities that are recognized or disclosed at fair value in the financial statements on a non-recurring basis. Non-recurring nonfinancial assets and nonfinancial liabilities for which we have not applied the provisions of SFAS 157 include those measured at fair value during impairment testing for goodwill and other long-lived assets and those initially measured at fair value in a business combination. We are currently assessing the impact of SFAS 157 for nonfinancial assets and nonfinancial liabilities on our consolidated financial position, results of operations and cash flows, but we do not believe it will have a material impact on the Company.

In December 2007, the FASB issued SFAS No. 141(R), Business Combinations (SFAS 141(R)), which changes accounting for business acquisitions. SFAS 141(R) will require the acquiring entity in a business combination to recognize all (and only) the assets acquired and liabilities assumed in the transaction and establishes the acquisition-date fair value as the measurement objective for all assets acquired and liabilities assumed in a business combination. Certain provisions of this standard will, among other things, impact the determination of acquisition-date fair value of consideration paid in a business combination (including contingent consideration); exclude transaction costs from acquisition accounting; and change accounting practices for acquired contingencies, acquisition-related restructuring costs, in-process research and development, indemnification assets and tax benefits. SFAS 141(R) will be effective for us for business combinations occurring after December 31, 2008. The impact on the our consolidated financial statements of adopting SFAS No. 141(R) will depend on the nature, terms and size of business combinations completed after December 31, 2008.

Cautionary Statement Regarding Forward-Looking Information

Vital Images desires to take advantage of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995 (the Reform Act) and is filing this cautionary statement in connection with the Reform Act. This Quarterly Report on Form 10-Q and any other written or oral statements made by or on our behalf may include forward-looking statements that reflect our current views with respect to future events and future financial performance. Certain statements in this Quarterly Report on Form 10-Q are forward-looking statements within the meaning of Section 27(a) of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. You can identify these forward-looking statements by our use of the words believes, anticipates, forecasts, projects, could, plans, expects, may, will, would, intends, estimates and similar expressions, whether in the negative or affirmative. We wish to caution you that any forward-looking statements made by us or on our behalf are subject to uncertainties and other factors that could cause such statements to be wrong. We cannot guarantee that we actually will achieve these plans, intentions or expectations. Actual results or events could differ materially from the plans, intentions and expectations disclosed in the forward-looking statements that we make. These statements are only predictions and speak only of our views as of the date the statements were made. Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, and/or performance of achievements. We do not assume any obligation to update or revise any forward-looking statements that we make, whether as a result of new information, future events or otherwise.

Factors that may impact forward-looking statements include, among others, our abilities to maintain the technological competitiveness of our current products, develop new products, successfully market our products, respond to competitive developments, develop and maintain partnerships with providers of complementary technologies, identify and close mergers and acquisitions, manage our costs and the challenges that may come with growth of our business, and attract and retain qualified sales, technical and management employees. We are also affected by the growth and regulation of the medical technology industry, including the acceptance of enterprise-wide advanced visualization by hospitals, clinics, and universities, product clearances and approvals by the United States Food and Drug Administration and similar regulatory bodies outside the United States, and reimbursement and regulatory practices by Medicare, Medicaid, and private third-party payer organizations. We are also affected by other factors identified in our filings with the Securities and Exchange Commission, some of which are set forth in the section entitled Item 1A.Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2007 (and many of which we have discussed in prior filings). Although we have attempted to list comprehensively these important factors, we also wish to caution investors that other factors may prove to be important in the future in affecting our operating results. New factors emerge from time to time, and it is not possible for us to predict all of these factors, nor can we assess the impact each factor or combination of factors may have on our business.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

For information regarding our exposure to certain market risks, see Item 7A, Quantitative and Qualitative Disclosures About Market Risk, in our Annual Report on Form 10-K for the fiscal year ended December 31, 2007, which is hereby incorporated herein. There have been no significant changes in the financial instruments or market risk exposures from the amounts and descriptions disclosed therein.

Item 4. Controls and Procedures

Evaluation of disclosure controls and procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in the reports that we file or submit under the Securities Exchange Act of 1934, as amended (Exchange Act), is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required financial disclosure.

Our management, under the supervision of and with the participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, as of the end of the period covered by this report. Based on such evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of the period covered by this report, our disclosure controls and procedures were effective.

Limitations on the effectiveness of controls

Our management is responsible for establishing and maintaining adequate internal control over financial reporting. Our internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with established policies or procedures may deteriorate.

Changes in internal control over financial reporting

There were no changes in internal control over financial reporting during the quarter ended March 31, 2008 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Part II. Other Information

Item 1. Legal Proceedings

None.

Item 1A. Risk Factors

The discussion of our business and operations included in this Quarterly Report on Form 10-Q should be read together with the risk factors described in Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2007. They describe various risks and uncertainties to which we are or may become subject. These risks and uncertainties, together with other factors described elsewhere in this report, have the potential to affect our business, financial condition, results of operations, cash flows, strategies or prospects in a material and adverse manner. New risks may emerge at any time, and we cannot predict those risks or estimate the extent to which they may affect financial performance.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None.

Item 3. Defaults upon Senior Securities

None.

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

None.

Item 5. Other Information

None.

Item 6. Exhibits

The following exhibits are filed with this Quarterly Report on Form 10-Q:

- 31.1 Certification of Chief Executive Officer Pursuant to Rules 13a-14(a)/15d-14(a) under the Securities Exchange Act of 1934 (filed herewith electronically).
- 31.2 Certification of Chief Financial Officer Pursuant to Rules 13a-14(a)/15d-14(a) under the Securities Exchange Act of 1934 (filed herewith electronically).
- 32.1 Section 1350 Certification of Chief Executive Officer (filed herewith electronically).
- 32.2 Section 1350 Certification of Chief Financial Officer (filed herewith electronically).

Signatures

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

May 12, 2008

VITAL IMAGES, INC.

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