MERGE TECHNOLOGIES INC
Form 10-K
August 30, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2005

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

For the transition period from to

Commission file number 0-29486

MERGE TECHNOLOGIES INCORPORATED

(Exact name of Registrant as specified in its charter)

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

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

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

Yes o No x

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

Yes o No x

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

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

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

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

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

Yes o No x

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

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

INDEX

MERGE TECHNOLOGIES INCORPORATED

EXPLANATORY NOTE RESTATEMENT OF FINANCIAL INFORMATION

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

PART I

Item 1. BUSINESS

Cautionary Note Regarding Forward-Looking Statements

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

Overview

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

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

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

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

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

We also focus on the development of custom-engineered software applications and development tools for the medical imaging and information OEM and International markets. Our software is deployed in hospitals and clinics worldwide through our partners and is licensed by many of the world s largest medical device and healthcare information technology (IT) companies as well as our Direct and eCommerce channels. Our technologies help our OEM customers increase revenues, create competitive advantages, and deliver technologies to end-user markets throughout the world. We may serve as an extended research and development team for the OEM, helping them to be first-to-market with innovative medical imaging technologies. We leverage our global end-user distribution channels to sell our customers existing technologies and applications, and expand the value of medical imaging solutions by licensing additional applications for our customers to sell through their own sales forces. Our technologies and expertise span all the major digital imaging modalities, including computed tomography (CT), magnetic resonance imaging (MRI), digital x-ray, mammography, ultrasound, echo-cardiology, angiography, nuclear medicine, positron emission tomography (PET) and fluoroscopy. Our offerings are used in all aspects of clinical imaging workflow, including: the capture of a patient s digital image; the archiving, communication and manipulation of digital images; sophisticated Clinical Applications to analyze digital images; the use of imaging in minimally-invasive surgery; and the management of patient information stored as Electronic Patient Records (EPR). We target OEM/VARs that serve all markets utilizing medical imaging in their businesses, regardless of the size or scope of the market they serve, including non-radiology markets such as oncology, pharmaceutical and EPR.

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

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

Our Market

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

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

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

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

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

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

Recent Challenges

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

History

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

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

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

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

How We Benefit Our Customers

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

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

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

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

Business Strategy

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

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

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

In line with this focused operational plan, we:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

End-User Products and Services Description

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

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

OEM Products and Services Descriptions

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

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

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

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

Merge Healthcare Product Portfolio

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

12

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

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

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

* Indicates products sold to Direct and OEM customers.

Employees

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

Sales, Marketing and Distribution

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

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

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

Competition

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

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

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

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

Intellectual Property Rights

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

Medical, Regulatory and Government Standards and Reforms

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

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

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

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

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

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

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

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

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

Other Information

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

Item 1A. RISK FACTORS

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

We have identified material weaknesses in our disclosure controls and procedures and our internal control over financial reporting, which, if not remedied effectively, could have an adverse effect on the trading price of our Common Stock and otherwise seriously harm our business As discussed in Item 9A, Controls and Procedures in Part II of this Annual Report on Form 10-K, from January 10, 2006 to May 26, 2006, we received 11 anonymous letters primarily alleging improprieties relating to our financial reporting, fulfillment of customer contracts and disclosure practices. More specifically, the letters contained allegations of improper revenue recognition practices. The Audit Committee retained the independent national law firm of Sidley Austin LLP and Alvarez & Marsal Dispute Analysis and Forensic Services, LLC (Alvarez & Marsal), a nationally-recognized forensic accounting firm, to conduct an independent investigation of the allegations contained in the anonymous letters. Based upon the normal year end closing process and the preliminary findings of the investigation, we identified certain errors in our financial statements for the second and third quarters of 2005. On June 29, 2006, Sidley Austin LLP reported its findings to the Audit Committee, and the Audit Committee determined that, because of improper accounting and financial reporting practices with respect to reporting periods in the fiscal years 2002 through 2005, the previously issued financial statements for each of the reporting periods in 2002 through 2005 should no longer be relied upon. See Item 9A, Controls and Procedures in Part II of this Annual Report on Form 10-K and Footnotes 12 and 13 to the notes to our consolidated financial statements in Part II, Item 8, Financial Statements and Supplementary Data to this Annual Report on Form 10-K for more information concerning the independent investigation. The investigation and the remedial actions resulting from the investigation have caused and will likely continue to cause uncertainty and disruption of our business and operations.

As discussed in Item 9A, as a consequence of the Audit Committee s determination that because of improper accounting and financial reporting practices with respect to reporting periods in the fiscal years 2002 through 2005, the previously issued financial statements for each of the reporting periods in 2002 through 2005 should no longer be relied upon. Our management has concluded that our disclosure controls and procedures were not effective and our internal control over financial reporting had material weaknesses as of December 31, 2005. Among other things, our control environment was not adequate because certain former members of senior management did not set a proper ethical tone within our organization and instill an attitude of compliance. Certain former members of our management were directly involved in circumventing our accounting controls, and other former members of our management were aware of, or should have been aware, that such controls were being circumvented. Further, we do not currently have an enterprise resource planning (ERP) system, and, accordingly, are unable to manage our operations or generate reports from a single integrated data set. Although we have taken actions to begin to address the material weaknesses, our inability to remedy such material weaknesses promptly and effectively could have a material adverse effect on the accuracy and completeness of our financial statements, as well as impair our ability to meet our quarterly and annual reporting requirements in a timely manner and could also have a material adverse effect on our business relationships and our reputation. Moreover, our remediation efforts will likely require the commitment of significant financial and managerial resources. Prior to the remediation of these material weaknesses, there remains the risk that the controls on which we currently rely will fail to be sufficiently effective, which could result in a material misstatement of our financial position or results of operations and require further restatement of our financial statements. If we are unable, or are perceived as unable, to produce reliable financial reports due to disclosure control or internal control deficiencies, investors could lose confidence in our reported financial information and our operating results and the market price of our Common Stock could be adversely affected. In addition, even if we are successful in strengthening our controls and procedures, such controls and procedures may not be adequate to prevent or identify misstatements or to provide reasonable assurance that our financial statements are prepared in conformity with United States of America generally accepted accounting principles (GAAP).

Litigation or regulatory actions could adversely affect our financial condition We, Richard A. Linden, our former President and Chief Executive Officer, and Scott T. Veech, our former Chief Financial Officer, are defendants in several lawsuits relating to our accounting and financial disclosure. In addition, Brian E. Pedlar, our former Senior Vice President and former President of Cedara Software Corp., who served as our interim co-President and interim co-Chief Executive Officer from July 2, 2006 to August 18, 2006, has been named in one of the lawsuits. Mr. Linden, Mr. Veech, William C. Mortimore (our founder, former Chairman and former Chief Strategist, who served as our interim Chief Executive Officer from May 15, 2006 to July 2, 2006) and all of the members of our Board of Directors are also defendants in a derivative action, alleging breaches of fiduciary duties and failure to hold a 2006 annual meeting of shareholders. These lawsuits and other legal matters in which we have become involved, are described in Item 3, Legal Proceedings in Part I of this Annual Report on Form 10-K. Those lawsuits present material and significant risk to us. We are unable at this time to predict the outcome of these actions or reasonably estimate a range of damages in the event plaintiffs in these or other potential matters relating to the same events prevail under one or more of their claims.

The Midwest Office of the Securities and Exchange Commission (SEC) has notified us that we are the subject of an informal, non-public inquiry. We are cooperating with the SEC in response to its request for information. The inquiry generally concerns our financial statement restatements and the anonymous letters we have received regarding our accounting and financial disclosure. We cannot predict whether the SEC will expand the scope of its inquiry or obtain a formal order of investigation.

These lawsuits and regulatory matters are having, and will continue to have, a disruptive effect upon the operations of the business, including the diversion of significant time and attention of our senior management, which have adversely affected our results of operations for the first and second quarters of fiscal 2006 and we expect will affect our results of operations for at least the remainder of 2006. In addition, we are likely to incur substantial expenses in connection with such matters, including substantial fees for attorneys and other professional advisors.

We have purchased Directors and Officers (D&O) liability insurance that may provide coverage for some or all of these matters. However, there is risk that the D&O insurers will attempt to rescind the policies; that some or all of the claims will not be covered by such policies; or that, even if covered, our ultimate liability will exceed the available insurance.

We may be unable to maintain our listing on the NASDAQ Global Market, which could impact our ability to secure financing, cause our stock price to fall and decrease the liquidity of our Common Stock Our Common Stock is currently listed on the NASDAQ National Market (now designated the NASDAQ Global Market). The continued listing of our Common Stock requires us to meet certain quantitative and qualitative standards, including the timely filing of our periodic reports with the SEC. On March 20, 2006, May 16, 2006 and August 14, 2006, we received written notifications from the staff of The NASDAQ Stock Market that we were not in compliance with National Association of Securities Dealers (NASD) rules because we did not timely file our Form 10-K for the year ended December 31, 2005 and our Forms 10-Q for the first and second quarter of 2006, and that our Common Stock was, therefore, subject to delisting from the NASDAQ Global Market. On July 11, 2006, we announced that we had received written notification from the NASDAQ Listing Qualifications Panel stating that the Panel determined to continue the listing of our common stock subject to our filing of our Form 10-K, our Form 10-Q for the quarter ended March 31, 2006 and all required restatements by no later than August 29, 2006. On August 30, 2006, before the commencement of trading on the NASDAQ Global Market, we filed this Form 10-K and our Form 10-Q for the quarter ended March 31, 2006 with the SEC. We have not yet filed our Form 10-Q for the quarter ended June 30, 2006. We have requested that the Panel grant us an additional extension until September 8, 2006 to regain compliance with the NASDAQ listing requirements by filing our Form 10-Q for the quarter ended June 30, 2006, but we cannot be certain that the Panel will grant this request. In any event, we will not be certain that our Common Stock will remain listed on the NASDAQ Global Market until we receive notification from the NASDAQ Listing Qualifications Panel that all conditions to our continued listing on the NASDAQ Global Market have been satisfied.

If delisting of our Common Stock occurs, the trading of our Common Stock may be conducted on the Over The Counter Bulletin Board or the Pink Sheets. If our Common Stock is delisted and we are not at that time current in our SEC filings, our Common Stock will trade on the Pink Sheets. The delisting of our Common Stock from the NASDAQ Global Market would result in decreased liquidity of our outstanding shares of our Common Stock (and a resulting decrease in the ability of our shareholders to sell our Common Stock or obtain timely quotations as to their market value). For example, certain institutions may be unwilling or unable to hold our shares in the event that our Common Stock were to be delisted. To the extent they currently hold our Common Stock, such institutions could be required to divest their holdings, which could impose additional downward pressure on the price of our Common Stock. The delisting of our Common Stock could also deter broker-dealers from making a market in or otherwise generating interest in our Common Stock and might deter certain persons from investing in our Common Stock. Furthermore, our ability to raise additional capital through equity or debt financing could be severely impaired, which could materially adversely affect our liquidity and financial condition. As a result of these factors, the value of the Common Stock could decline significantly and our stockholders could lose some or all of their investment.

The turnover in our management team could negatively impact our business and the trading price of our Common Stock On May 15, 2006, our Board of Directors accepted the resignation of Richard A. Linden,

our former President and Chief Executive Officer, from all positions with us and our subsidiaries, including as an officer, employee and director. At the same time, we appointed William C. Mortimore, who founded the Company and was then serving as our Chairman and Chief Strategist, as our interim Chief Executive Officer. Six weeks later, on July 2, 2006, our Board of Directors accepted the resignations of Mr. Mortimore, Scott T. Veech, our former Chief Financial Officer, Treasurer and Secretary, and David M. Noshay, our former Senior Vice President, Strategic Business Development, from all positions with us and our subsidiaries, including as officers, employees and directors. At the same time, our Board appointed Michael D. Dunham, the Chairman of our Board of Directors, as our principal executive officer on an interim basis, and Brian E. Pedlar, who had been serving as Senior Vice President of Merge Healthcare and President of Cedara Software Corp., and Robert J. White, who had been serving as Senior Vice President of Merge Healthcare and President of Merge eMed, were each appointed as our co-President and co-Chief Executive Officer on an interim basis. On August 17, 2006, we received a written notification from Mr. Pedlar s counsel of Mr. Pedlar s departure from us and our subsidiaries, effective as of the close of business on August 18, 2006. Our Board is searching for a new Chief Executive Officer.

On July 2, 2006, the Board also appointed Steven M. Oreskovich, who had been serving as our Vice President and Corporate Controller, as our Chief Accounting Officer and interim Treasurer and Secretary. Mr. Oreskovich will serve as our principal accounting officer and interim principal financial officer. Our Board is searching for a Chief Financial Officer.

We may not be able to find, attract and retain a suitable new Chief Executive Officer and Chief Financial Officer on acceptable terms. The new members of our management team may need to devote a significant amount of time to learning about our business and its markets, which could limit their effectiveness in managing our business for a period of time. Further, there will likely be significant uncertainty as to how we will perform under new leadership.

With the recent departures of five of our senior executives, we lost persons with a significant amount of experience and knowledge about our business, our customers and our industry and strong relationships with our customers, suppliers and employees. We believe that the turnover of our senior management has created uncertainty that has adversely affected our relationships with our customers and employees and also our reputation in the marketplace. Mr. White, who is President of Merge eMed and has been serving as our interim President and Chief Executive Officer, has only been with us for a short time (since April 2006) and continues to learn about our business. Similarly, Mr. Oreskovich was only recently given the responsibilities of principal accounting officer and interim principal financial officer. We may not be successful if the members of our management team, including our new Chief Executive Officer and new Chief Financial Officer, once hired, cannot effectively manage and operate our business.

Our performance and future success depends on our ability to attract, integrate and retain qualified technical, managerial and sales personnel We are dependent, in part, upon the services of our senior executives, some of whom are new hires or have recently assumed new roles, and other key business and technical personnel. We do not maintain key-man life insurance on our senior executives. The loss of the services of any of our senior executives or key employees could have a material adverse effect on us. Our continued commercialization will depend upon, among other things, the successful recruiting and retention of highly skilled technical, managerial and sales personnel with experience in business activities such as ours. Competition for the type of highly skilled individuals sought by us is intense. We may not be able to retain existing key employees or be able to find, attract and retain skilled personnel on acceptable terms.

Relationships with our customers, potential customers and suppliers may be adversely affected, and our competitors competitive position improved, by our restatement of our financial results, related and regulatory proceedings, potential NASDAQ delisting and management turnover Due to our restatement of our financial statements, related litigation and regulatory proceedings, potential NASDAQ delisting and uncertainty regarding changes in our senior management team, our customers and potential customers, new or existing suppliers or others may have concerns that we will become unreliable in operating our business. As a

result, we may experience a decrease in the number of new customers or reluctance on the part of existing customers to renew their contracts with us. In addition, we may experience a loss of other important business relationships. If our customers, potential customers, suppliers or others lose confidence in our ability to operate our business, our business may be materially harmed and our competitors competitive position relative to us may be improved.

Our ability to obtain D&O liability insurance in the future may be adversely affected by the lawsuits and regulatory actions against us and certain of our executive officers The lawsuits and regulatory actions described above, and the facts underlying them, may make director and officer liability insurance extremely expensive or unavailable for us in the future. Increased premiums could materially harm our financial results in future periods. The inability to obtain this coverage due to its unavailability or prohibitively expensive premiums would make it more difficult to retain and attract officers and directors and expose us to potentially self-funding any potential future liabilities ordinarily mitigated by director and officer liability insurance.

Our quarterly net sales may vary significantly 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, but not limited to, demand for our software solutions and services, our sales cycle, economic cycles, the level of reimbursements to our end-user customers from government sponsored healthcare programs (principally, Medicare and Medicaid), accounting policy changes mandated by regulating entities, and other factors described in this section and elsewhere in this report. As a result of healthcare industry trends and the market for our RIS, PACS or RIS/PACS solutions, a large percentage of our revenues are generated by sale and installation of systems sold directly to healthcare institutions. The sales may be subject to delays due to customers internal budgets and procedures for approving capital expenditures and by competing needs for other capital expenditures, the deployment of new technologies and 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.

Additionally, we generally depend, in part, upon large contracts with a small number of OEMs to meet our sales goals in any particular quarter. For example, one customer accounted for approximately 37% of our total net sales for the three months ended September 30, 2005, and during the three months ended December 31, 2005, another customer accounted for approximately 27% of our total net sales. Delays in the expected sale or installation of solutions under these large contracts may have a significant impact on our quarterly revenues and consequently our earnings, particularly because a significant percentage of our expenses are fixed.

Recognition of certain of our revenues may be deferred Recognition of all or a portion of revenue under certain customer agreements, including license fees and related professional and consulting fees, may be deferred in accordance with applicable accounting standards. Software revenue is generally recognized at the time of shipment to our customers, provided that services are not considered as essential to the functionality of the software, the contract terms are fixed and determinable, collection is probable, and we have vendor specific objective evidence (VSOE) of fair value of the undelivered contract elements.

Software revenue from sales of RIS and RIS/PACS solutions, where consulting and installation services are generally considered essential to the functionality of the software, are recognized on the percentage-of-completion method as the services are performed. We estimate the number of days that services will have to be provided under each contract relating to such sales to estimate the percentage of completion. At times, we have had difficulty accurately estimating the number of days required to complete the consulting and installation services and, accordingly, accurately estimating the percentages of completion.

The length of our sales and implementation cycles may adversely affect our future operating results We have experienced long sales and implementation cycles. How and when to implement, replace, expand or

substantially modify medical imaging management software, or modify or add business processes, are major decisions for our end-user target market. Furthermore, our software generally requires significant capital expenditures by our customers. The sales cycle for our software ranges from 6 to 18 months or more from initial contact to contract execution. Our implementation cycle has generally ranged from 3 to 9 months from contract execution to completion of implementation. During the sales and implementation cycles, we will expend substantial time, effort and resources preparing contract proposals, negotiating the contract and implementing the software. We may not realize any revenues to offset these expenditures. Additionally, any decision by our customers to delay or cancel purchases or the implementation of our software may adversely affect our revenues.

Our dependence on a limited number of suppliers for software and hardware could adversely impact our business and results of operations Our access to certain software and hardware components is dependent in some cases upon single and sole source suppliers. The inability of any supplier to fulfill our supply requirements could adversely affect our business and results of operations.

We face aggressive competition in many areas of our business, and our business will be harmed if we fail to compete effectively The market for medical imaging solutions is highly competitive and subject to rapid technological change. We may be unable to maintain our competitive position against our current and potential competitors. Many of our current and potential competitors have greater financial, technical, product development, marketing and other resources than we have, and we may not be able to compete effectively with them. In addition, new competitors may emerge and our system and software solution offerings may be threatened by new technologies or market trends that reduce the value of our solutions.

The development and acquisition of additional products and technologies, and the improvement of our existing products requires significant investments in research and development. For example, our current product candidates are in various stages of development, and may require significant further research, development, pre-clinical or clinical testing, regulatory approval and commercialization. We also may not have devoted adequate resources to the development and acquisition of additional products since our June 2005 business combination with Cedara Software Corp. If we fail to successfully sell new products and update our existing products, our operating results may decline as our existing products reach the end of their commercial life cycles.

Our proprietary technology may be subjected to infringement claims or may be infringed upon which could result in additional costs or lost sales Our success depends, in part, on our ability and the ability of our licensors to obtain, assert and defend patent rights, protect trade secrets and operate without infringing the proprietary rights of others. We currently own or have rights to a number of U. S. patents and have a number of outstanding patent applications. We may not, however, be able to obtain additional licenses to patents of others or be able to develop additional patentable technology of our own. Any patents issued to us may not provide us with competitive advantages, or the patents or proprietary rights of others may have an adverse effect on our ability to do business. Others may independently develop similar products or design around or infringe such patents or proprietary rights owned by or licensed to us. Any patent obtained or licensed by us may not be held to be valid and enforceable if challenged by another party.

Although we endeavor to protect our patent rights from infringement, we may not be aware, or become aware, of patents issued to our competitors or others that conflict with our own. Such conflicts could result in a rejection of important patent applications or the invalidation of important patents, which could have a materially adverse effect on our competitive position. In the event of such conflicts, or in the event we believe that competitive products infringe patents to which we hold rights or others believe that our products infringe patents to which they hold rights, we may pursue patent infringement litigation or interference proceedings against, or may be required to defend against such litigation or proceedings involving holders of such conflicting patents or competing products. Such litigation or proceedings may have a materially adverse effect on our competitive position, and there can be no assurance that we will be successful in any such litigation or proceeding. Litigation and other proceedings relating to patent matters,

whether initiated by us or a third party, can be expensive and time consuming, regardless of whether the outcome is favorable to us, and can result in the diversion of substantial financial, managerial and other resources. An adverse outcome could subject us to significant liabilities to third parties or require us to cease any related development or commercialization activities. In addition, if patents that contain dominating or conflicting claims have been or are subsequently issued to others and such claims are ultimately determined to be valid, we may be required to obtain licenses under patents or other proprietary rights of others. Any licenses required under any such patents or proprietary rights may not be made available on terms acceptable to us, if at all. If we do not obtain such licenses, we could encounter delays or could find that the development, manufacture or sale of products requiring such licenses is foreclosed.

We also rely on proprietary know how and confidential information and employ various methods, such as entering into confidentiality and non-compete agreements with our current employees and with certain third parties to whom we have divulged proprietary information, to protect the processes, concepts, ideas and documentation associated with our solutions. Such methods may not afford sufficient protection to us, and may not be able to adequately protect our trade secrets or ensure that other companies would not acquire information that we consider proprietary.

We depend on licenses from third parties for rights to some technology we use, and if we are unable to continue these relationships and maintain our rights to this technology, our business could suffer We depend upon licenses for some of the technology used in our software from a number of third party vendors. These licenses are provided to us under contracts that typically expire within one to five years, can be renewed only by mutual consent and may be terminated if we breach the terms of the contract and fail to cure the breach within a specified period of time. We may not be able to continue using the technology made available to us under these contracts on commercially reasonable terms or at all. As a result, we may have to discontinue, delay or reduce software shipments until we obtain equivalent technology, which could hurt our business. Most of our third party licenses are nonexclusive. Our competitors may obtain the right to use any of the technology covered by these licenses and use the technology to compete directly with us. In addition, if our vendors choose to discontinue support of the licensed technology in the future or are unsuccessful in their continued research and development efforts, particularly with regard to the Microsoft Windows/Intel platform on which most of our products operate, we may not be able to modify or adapt our own software.

We are subject to government regulation, changes to which could negatively impact our business We are subject to regulation in the U.S. by the United States Food and Drug Administration (FDA), including periodic FDA inspections, in Canada under Health Canada s Medical Devices Regulations, and in other countries by corresponding regulatory authorities. There can be no assurances that we will not be required to undertake additional actions in the U.S. to comply with the Federal Food, Drug and Cosmetic Act (the Act), its implementing regulations and any other applicable regulatory requirements. For example, the FDA has increased its focus on regulating computer software intended for the use in a healthcare setting. 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 activities. Complying with these regulations could be time consuming and expensive, and may include:

- requiring us to receive FDA clearance of a pre-market notification submission demonstrating substantial equivalence to a device already legally marketed, or to obtain FDA approval of a pre-market approval application establishing the safety and effectiveness of the software;

- requiring us to comply with rigorous regulations governing the pre-clinical and clinical testing, manufacture, distribution, labeling and promotion of medical devices; and

- requiring us to comply with the Act regarding general controls, including establishment registration, device listing, compliance with good manufacturing practices, reporting of specified malfunctions and adverse device events.

Similar obligations may exist in other countries in which we do business, including Canada. Any failure by us to comply with the Act and any other applicable regulatory requirements, both domestic and foreign, could subject us to a number of enforcement actions, including warning letters, fines, product seizures, recalls, injunctions, total or partial suspension of production, operating restrictions or limitations on marketing, refusal of the government to grant new clearances or approvals, withdrawal of marketing clearances or approvals and civil and criminal penalties.

Changes in the healthcare industry, including the changes to reimbursement schedules under the Deficit Reduction Act of 2005, could negatively impact our business The healthcare industry is highly regulated and is subject to changing political, economic and regulatory influences. These factors affect the purchasing practices and operation of healthcare organizations. Federal and state legislatures have periodically considered programs to reform the U. S. healthcare system and to change healthcare financing and reimbursement systems. In 2005, Congress legislated an increase (fee schedule update) of approximately 1.5% in the overall reimbursement rates for physician and outpatient services, including diagnostic imaging services. On February 8, 2006, the President signed into law the Deficit Reduction Act of 2005 (DRA). Effective for services provided on or after January 1, 2007, the DRA provides that reimbursement for the technical component for imaging services (excluding diagnostic and screening mammography) in non-hospital based freestanding facilities will be capped at the lesser of reimbursement under the Medicare Part B physician fee schedule or the Hospital Outpatient Prospective Payment System (HOPPS) schedule. The DRA also codifies the reduction in reimbursement for multiple images on contiguous body parts previously announced by the Centers for Medicare and Medicaid Services (CMS). In November 2005, CMS announced that it would pay 100% of the technical component of the higher priced imaging procedure and 50% for the technical component of each additional imaging procedure for imaging procedures involving contiguous body parts within a family of codes when performed in the same session. Under current methodology, Medicare pays 100% of the technical component of each procedure. CMS will phase in this rate reduction over two years, so that the reduction will be 25% for each additional imaging procedure in 2006 and another 25% in 2007.

A significant portion of our net sales are directly or indirectly derived from sales to end-users, including hospitals, diagnostic imaging centers and specialty clinics, many of which generate some or all of their revenues from government sponsored healthcare programs (principally, Medicare and Medicaid). We believe that the implementation of the reimbursement reductions contained in the DRA will adversely impact our end-user customers revenues, which may cause some of them to respond by reducing their investments or postponing investment decisions, including investments in our software solutions and services.

Changes in federal and state regulations relating to patient data could depress the demand for our software and impose significant software redesign costs on us Federal regulations under HIPAA impose national health data standards on healthcare providers that conduct electronic health transactions, healthcare clearinghouses that convert health data between HIPAA compliant and non-compliant formats and health plans. Collectively, these groups are known as covered entities. The HIPAA regulations prescribe transaction formats and code sets for electronic health transactions; protect individual privacy by limiting the uses and disclosures of individually identifiable health information; and require covered entities to implement administrative, physical and technological safeguards to ensure the confidentiality, integrity, availability and security of individually identifiable health information in electronic form. Though we are not a covered entity, most of our customers are and require that our software and services adhere to HIPAA regulations. Any failure or perception of failure of our software or services to meet HIPAA regulations could adversely affect demand for our software and services and force us to potentially expend significant capital, research and development and other resources to modify our software or services to address the privacy and security requirements of our clients.

States and foreign jurisdictions in which our clients or we operate have adopted, or may adopt, privacy standards that are similar to or more stringent than the federal HIPAA privacy regulations. This may lead to different restrictions for handling individually identifiable health information. As a result, our customers may demand IT solutions and services that are adaptable to reflect different and changing regulatory requirements, which could increase our development costs. In the future, federal, state or foreign governmental authorities may impose new data security regulations or additional restrictions on the collection, use, transmission and other disclosures of health information. We cannot predict the potential impact that these future rules may have on our business; however, the demand for our software and services may decrease if we are not able to develop and offer software and services that can address the regulatory challenges and compliance obligations facing our clients.

The complexity presented by international operations could negatively affect our business Revenues from customers headquartered outside of the U. S., which we classify as international revenues, account for a material portion of our revenues. Net sales from our international locations accounted for approximately 41% of our total net sales for the year ended December 31, 2005, 32% of our total net sales for the year ended December 31, 2004 and 43% of our total net sales for the year ended December 31, 2003. While we plan to continue expanding our presence in international markets, our international operations present a number of risks, including the following:

- greater difficulty in collecting accounts receivable and longer collection periods;
- potentially unfavorable economic conditions outside of the U. S.;
- changes in local currencies may impact the attractiveness of our product competitiveness as we invoice most of our net sales in U. S. Dollars;
- certification requirements;
- lack of, or limited 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;
- potential adverse impact on the demand for products and services of U. S.-based businesses due to global perceptions regarding U. S. foreign policy;
- natural disasters, war or terrorist acts;
- ineffective strategic relationships with international partners; and
- political conditions which may threaten the safety of our employees or the employees of our customers or our continued presence in foreign countries.

We provide our customers with certain warranties which could result in higher costs than we anticipate Software products as complex as those offered by us and used in a wide range of clinical and health information systems settings are likely to contain a number of errors or bugs, especially early in their product life cycle. Our products are clinical information systems used in patient care settings where a low tolerance for bugs exists. Testing of products is difficult due to the wide range of environments in which systems are installed. The discovery of defects or errors in our software products may cause delays in product delivery, poor client references, payment disputes, contract cancellations, or additional

expenses and payments to rectify problems. Any of those factors may result in delayed acceptance of, or the return of, our software products, which could have a material adverse effect upon results of operations or financial condition, business and reputation.

We may be unable to successfully integrate acquisitions, which could negatively impact our results We have experienced significant challenges integrating Merge Healthcare s and Cedara Software Corp. s businesses and personnel. In particular, we have struggled to realize synergistic benefits as a consequence of organizational changes, primarily within our sales and service groups, following our June 1, 2005 business combination with Cedara Software Corp. We may continue to acquire or make investments in complementary businesses, products or technologies. The process of integrating any acquired business, product or technology into our business and operations may result in unforeseen operating difficulties and expenditures. Any acquisition may involve a number of risks, including:

- an increase in our expenses and working capital requirements in connection with the integration of the personnel, operations, technologies or products of the acquired companies;

- other financial risks, such as potential liabilities associated with the businesses that we acquire;

- diversion of capital and management s attention from our core business;

- adverse effects on business relationships with our existing customers and suppliers and those of the acquired company;

- an increased risk that we become the subject of litigation regarding intellectual property or other matters;

- difficulty in successfully implementing acquired operations, IT systems, customers, OEM supplier and partner relationships, products and business with our operations;

- acquired assets becoming impaired as a result of technical advancements or worse than expected performance by the acquired company;

- entering markets in which we have no, or limited, prior experience; and

- potential loss of our key employees and those of the acquired company.

In addition, in connection with any business combinations or acquisitions or investments we could:

- issue stock that would dilute existing shareholders percentage of ownership;

- incur debt and assume liabilities;

- obtain financing on unfavorable terms;

- incur amortization expenses related to acquired intangible assets, or incur large write-offs (see Part II, Item 9B, Other Information, in this Annual Report on Form 10-K);

- incur significant expenditures related to office closures of the acquired companies, including costs relating to termination of employees and leasehold improvement charges relating to vacating the acquired companies or our premises; and

- reduce the cash that would otherwise be available to fund operations or to use for other purposes.

Product liability suits against us could result in expensive and time consuming litigation, payment of substantial damages and an increase in our insurance rates Many of our software solutions provide data for use by healthcare providers in clinical decision

making and creating patient treatment plans. If our software fails to provide accurate and timely information, or if our content or any other element of our software is associated with faulty clinical decisions or treatment, we could be exposed to claims of liability by customers, clinicians or patients against us relating to the use of our software solutions. The assertion of such claims, whether or not valid, and ensuing litigation, regardless of its outcome, could result in substantial cost to us, divert management s attention from our operations and decrease market acceptance of our software. The allocations of responsibility and limitations of liability set forth in our contracts may not be enforceable, may not be binding upon patients, or may not otherwise protect us from liability for

damages. Although we maintain product liability insurance coverage, our coverage may not cover a particular claim that may be brought in the future, prove to be adequate or that may not be available in the future 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.

Beginning in fiscal 2006, under SFAS No. 123(R) we will begin recording compensation expense in connection with the stock options provided to our employees and directors which may have a significant negative impact on future operating results In December 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 123 (revised), *Share-Based Payment* (SFAS No. 123(R)), which requires companies to measure all employee stock-based compensation awards using a fair value method and record such expense in the consolidated financial statements. The impact of adoption of SFAS No. 123(R) depends on, among other things, levels of share-based payments granted in the future, the market value of our Common Stock as well as assumptions regarding a number of complex variables. These variables include, but are not limited to, our stock price, volatility, and employee stock option exercise behaviors and the related tax impact. The expense recorded in future periods may significantly reduce future earnings. For example, in 2006, we expect that the application of SFAS No. 123(R) will reduce our net income by at least $3.4 million. Additionally, as a result of our combination with Cedara Software Corp., a significant number of our option holders are residents of Canada. Although we will incur expense under SFAS No. 123(R) for options held by Canadian residents like those held by U.S. residents, we do not receive a tax benefit with respect to options exercised by Canadian residents such as we receive with respect to options exercised by U. S. residents.

We may not be able to generate sufficient cash from our operations to meet our future operating, financing and capital requirements At June 30, 2006, our cash and cash equivalents were approximately $60 million. Our uses of cash in 2006 and future periods will depend on a variety of factors such as the amount of cash that we are required to devote to defend and address our outstanding legal and regulatory proceedings (see Part I, Item 3, Legal Proceedings, in this Annual Report on Form 10-K) and our capital expenditure plans. In the event that we are unable to generate sufficient cash from our operations to meet our short term or long term liquidity needs, we may need to raise additional capital. If we need to raise additional capital, selling additional equity or raising debt from third party sources may raise such capital. 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. Furthermore, these financing alternatives may not be available in amounts or on terms acceptable to us.

Our failure to timely provide Lincoln State Bank with annual financial statements for the year ended December 31, 2005 and interim financial statements for the quarters ended March 31, 2006 and June 30, 2006 constituted an event of default under our credit agreement. Accordingly, the obligation of Lincoln State Bank to extend us credit with respect to our $35 million line of credit terminated. We are currently negotiating a new credit agreement with Lincoln State Bank. There can be no assurance that Lincoln State Bank or any other lender will provide us with debt financing, or that any such financing will be provided in amounts or on terms acceptable to us.

We maintain substantial deposits of cash and cash equivalents at a limited number of financial institutions in excess of amounts covered by insurance. If one or more of these financial institutions fail, our financial condition may be adversely affected Substantially all of our cash and cash equivalents are held at a few financial institutions located in the U. S., Canada and the Netherlands. Deposits held with these banks exceed the amount of insurance, if any, provided on such deposits and, with respect to one such banking institution, we are one of the largest depositors. If one or more of these financial institutions were to fail and we are unable to timely recover the cash and cash equivalents deposited at such institution, it could adversely affect our financial condition.

Healthcare industry consolidation could impose pressure on our software prices, reduce our potential client base and reduce demand for our software Many hospitals and imaging centers have consolidated to create

larger healthcare enterprises with greater market power. If this consolidation trend continues, it could reduce the size of our target market and give the resulting enterprises greater bargaining power, which may lead to erosion of the prices for our software. In addition, when hospitals and imaging centers combine, they often consolidate infrastructure, and acquisition of our customers could erode our revenue base.

The trading price of our Common Stock has been volatile and may fluctuate substantially in the future The price of our Common Stock has been, and is likely to continue to be, volatile. For example, the closing price of our Common Stock from January 1, 2006 through August 28, 2006 was as high as $27.36 and as low as $6.43. The trading price of our Common Stock may fluctuate widely as a result of a number of factors, some of which are not in our control, including:

- Our ability to meet or exceed the expectations of analysts or investors;
- Changes in our own forecasts or earnings estimates by analysts;
- Perceptions regarding how our operating results presented in accordance with GAAP compare to forecasts of non-GAAP measures for our operating results;
- Quarter-to-quarter variations in our operating results;
- Announcements regarding clinical activities or new products by our competitors or us;
- General conditions in the healthcare IT industry;
- Governmental regulatory action and healthcare reform measures, including changes in reimbursement rates for imaging procedures;
- Rumors about our performance or software solutions;
- Price and volume fluctuations in the overall stock market, which have particularly affected the market prices of many software, healthcare and technology companies; and
- General economic conditions.

In addition, the market for our Common Stock may experience price and volume fluctuations unrelated or disproportionate to our operating performance. As a result, you may not be able to sell shares of our Common Stock at or above the price at which you purchased them.

Item 1B. UNRESOLVED STAFF COMMENTS

None.

Item 2. PROPERTIES

Our principal facilities are located in Milwaukee, Wisconsin in an approximately 22,000 square foot office leased through April 2011 at a rate of approximately $300 per year, and in Toronto, Ontario in an approximately 75,000 square foot office leased through December 31, 2009 at a rate of approximately CDN $1.1 million per year. We also have subsidiary or branch locations with leased facilities in Mississauga, Canada; Hudson, Ohio; Burlington, Massachusetts; San Francisco, California; Nuenen, the Netherlands; Paris, France; Tokyo, Japan and Shanghai, China. On June 1, 2006, we signed a letter exercising our right to lease an additional 14,000 square feet at our Milwaukee facility, commencing September 1, 2006 through April 2011.

We actively monitor our real estate needs in light of our current utilization and projected growth. We believe that we can acquire any necessary additional facility capacity on reasonably acceptable terms within a relatively short timeframe. We devote capital resources to facility improvements and expansions as we deem necessary to promote growth and most effectively serve our customers.

27

Item 3. LEGAL PROCEEDINGS

Between March 22, 2006 and April 26, 2006, seven putative securities class action lawsuits were filed in the United States District Court for the Eastern District of Wisconsin, on behalf of a class of persons who acquired shares of our Common Stock between August 2, 2005 and March 16, 2006, against us, Richard A. Linden, our former President and Chief Executive Officer, and Scott T. Veech, our former Chief Financial Officer; one of the suits also names Brian E. Pedlar, former President of Cedara Software Corp. and our former Senior Vice President, who served as our interim co-President and co-Chief Executive Officer from July 2, 2006 to August 18, 2006. One case has been voluntarily dismissed. The cases arise out of our March 17, 2006 announcement that that we would revise our results of operations for the fiscal quarters ended June 30, 2005 and September 30, 2005, as well as our investigation of allegations made in anonymous letters received by us. The lawsuits allege that we and individual defendants violated Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, as amended (the Exchange Act). The complaints seek damages in unspecified amounts. Competing motions for the appointment of lead plaintiff have been filed, but they have not yet been ruled upon by the Court. We intend to vigorously defend these lawsuits, including, but not limited to, possibly moving to dismiss the consolidated amended complaint when filed.

On August 28, 2006, a derivative action was filed in the Circuit Court of Milwaukee County, Civil Division, against Messrs. Linden, Mortimore and Veech, all of the current members of our Board of Directors. The plaintiffs allege that each of the individual defendants breached fiduciary duties to us by violating generally accepted accounting principles, willfully ignoring problems with accounting and internal control practices and procedures and participating in the dissemination of false financial statements and also allege that we and the director defendants failed to hold an annual meeting of shareholders for 2006 in violation of Wisconsin law. The plaintiffs ask for unspecified amounts in damages and costs, as well as equitable relief.

On April 27, 2006, we received an informal, nonpublic inquiry from the SEC requesting voluntary production of documents and other information. The inquiry principally relates to our announcement on March 17, 2006 that we would revise our results of operations for the fiscal quarters ended June 30, 2005 and September 30, 2005, as well as our investigation of allegations made in anonymous letters received by us. The SEC has advised us that this inquiry should not be interpreted as an adverse reflection on any entity or individual involved, nor should it be interpreted as an indication by the SEC that any violation of the federal securities laws has occurred. We are cooperating with the SEC.

In March 2006, the patent infringement lawsuit filed by ScheduleQuest, Inc. was dismissed.

We, and our subsidiaries, are from time to time parties to legal proceedings, lawsuits and other claims incident to our business activities. Such matters may include, among other things, assertions of contract breach or intellectual property infringement, claims for indemnity arising in the course of our business and claims by persons whose employment has been terminated. Such matters are subject to many uncertainties and outcomes are not predictable with assurance. Consequently, we may be unable to ascertain the ultimate aggregate amount of monetary liability, amounts which may be covered by insurance or recoverable from third parties, or the financial impact with respect to these matters as of the date of this report.

Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of security holders during the fourth quarter of 2005.

PART II

Item 5. MARKET FOR REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Our Common Stock commenced trading on the NASDAQ SmallCap Market on January 29, 1998, under the symbol MRGE. On June 3, 2003, our Common Stock commenced trading on the NASDAQ National Market (now designated the NASDAQ Global Market) (NASDAQ). On March 20, 2006, we received a written notification from the staff of the NASDAQ stating that we were not in compliance with NASD Marketplace Rule 4310(c)(14) because we did not timely file our Annual Report on Form 10-K for the year ended December 31, 2005, and that our Common Stock was, therefore, subject to delisting from the NASDAQ. On April 20, 2006, three of our independent directors and one of our officers appeared before a NASDAQ Listing Qualifications Panel to, among other things, request that the panel grant us an extension until June 30, 2006 to regain compliance with the filing requirement. We received a second notification from the staff on May 16, 2006, stating that our failure to timely file our Quarterly Report on Form 10-Q for the quarter ended March 31, 2006, would serve as an additional basis for delisting our Common Stock. On May 31, 2006, we received written notification from the NASDAQ Listing Qualifications Panel stating that it had determined to continue the listing of our Common Stock on the NASDAQ subject to our filing of this Annual Report on Form 10-K for the year ended December 31, 2005, our Quarterly Report on Form 10-Q for the quarter ended March 31, 2006 and all required restatements by no later than July 7, 2006. When it became clear that we would be unable to file these reports by July 7, 2006, we requested an additional extension until September 30, 2006 to regain compliance with the NASDAQ listing requirements. On July 11, 2006, we received written notification from the NASDAQ Listing Qualifications Panel stating that the Panel determined to continue the listing of our Common Stock subject to our filing of this Annual Report on Form 10-K, our Quarterly Report on Form 10-Q for the quarter ended March 31, 2006 and all required restatements by no later than August 29, 2006. On August 14, 2006, we received a written notification from the Panel stating that our failure to timely file our Quarterly Report on Form 10-Q for the quarter ended June 30, 2006 would serve as an additional basis for delisting our Common Stock from the NASDAQ Global Market. On August 30, 2006, before the commencement of trading on the NASDAQ Global Market, we filed this Form 10-K and our Form 10-Q for the quarter ended March 31, 2006. We have not yet filed our Form 10-Q for the quarter ended June 30, 2006. We have requested that the Panel grant us an additional extension until September 8, 2006 to regain compliance with the NASDAQ listing requirements by filing our Form 10-Q for the quarter ended June 30, 2006, and expect to file that Form 10-Q by this requested additional extension date. See Part I, Item 1A, Risk Factors, to this Annual Report on Form 10-K for a discussion of the risks and effects if we are unable to maintain our listing on the NASDAQ Global Market.

The following table sets forth for the periods indicated, the high and low sale prices of our Common Stock as reported by The Nasdaq Stock Market:

Common Stock Market Prices

	4th Quarter	3rd Quarter	2nd Quarter	1st Quarter
2005				
High	$ 30.05	$ 20.49	$ 20.00	$ 22.90
Low	$ 16.29	$ 16.50	$ 14.90	$ 17.05
2004				
High	$ 23.54	$ 17.94	$ 18.37	$ 20.10
Low	$ 16.39	$ 11.36	$ 13.16	$ 12.20

According to the records of American Stock Transfer & Trust Company, our registrar and transfer agent, we had 236 stockholders of record of Common Stock as of August 22, 2006. As of the same date, we estimate that there were in excess of 4,800 beneficial holders of our Common Stock.

Dividend Policy

We have not paid any cash dividends on our Common Stock since formation. We currently do not intend to declare or pay any cash dividends on our Common Stock in the foreseeable future.

Recent Sales of Unregistered Securities

We did not sell any shares of our Common Stock in transactions not registered under the Securities Act of 1933, as amended (the Securities Act) during the fourth quarter of 2005.

On March 1, 2006, we announced that our Board had authorized us to expand our stock repurchase program to a total of $20 million of our Common Stock, from the prior authorization of $10 million. This repurchase program expired on August 24, 2006, two years after its initial implementation, without any shares having been repurchased. Our Board has not made any decision as to if or when a similar program will be implemented.

Item 6. SELECTED FINANCIAL DATA

We have not amended our Annual Reports on Form 10-K or Quarterly Reports on Form 10-Q for the periods affected by the restatements and the financial statements and related financial information contained in such reports should no longer be relied upon. See Item 8 Financial Statements and Supplementary Data and Item 9A Controls and Procedures in Part II of this Annual Report on Form 10-K, and Notes 12 and 13 to the notes to consolidated financial statements, for more information concerning the restatements. The information that has been previously filed or otherwise reported for these periods is superseded by the information in this Annual Report on Form 10-K and in our Quarterly Reports on Form 10-Q for the quarter ended March 31, 2006, which is being filed contemporaneously with this Form 10-K.

	Year Ended December 31,				
	2005(1)	2004(2) (As restated)	2003(2) (As restated)	2002(2) (As restated	2001
	(in thousands, except for share and per share data)				
Statements of Operations Data:					
Net sales	$ 82,601	$ 26,347	$ 24,560	$ 19,147	$ 15,741
Operating income(3)	4,526	499	3,310	2,782	1,296
Income before income taxes	5,232	968	3,208	2,846	1,358
Income tax expense (benefit)	7,889	(1,222)	(1,226)	79	87
Net income (loss)	(2,657)	2,190	4,434	2,767	1,271
Earnings (loss) per share:					
Basic	$ (0.11)	$ 0.17	$ 0.38	$ 0.29	$ 0.17
Diluted	(0.11)	0.16	0.35	0.25	0.15
Weighted average shares outstanding:					
Basic	24,696,762	13,013,927	11,566,054	8,840,059	6,178,821
Diluted	24,696,762	13,827,522	12,586,900	10,383,651	7,310,731

	As of December 31,				
	2005	2004(2) (As restated)	2003(2) (As restated)	2002(2) (As restated)	2001
	(in thousands)				
Balance Sheet Data:					
Working capital	$ 57,336	$ 22,785	$ 18,187	$ 7,010	$ 2,628
Total assets(4)	501,673	85,491	66,085	27,481	10,056
Long-term debt obligations					159
Shareholders equity(4)	443,841	55,623	50,856	20,821	6,169

(1) Includes the results of Cedara Software Corp. from June 1, 2005, the date of our business combination.

(2) As disclosed under Explanatory Note Restatements of Financial Information immediately preceding Part I, Item 1 of this Annual Report on Form 10-K, we have restated certain financial data for the years ended December 31, 2004, 2003 and 2002. The effects on net sales related to these restatements were a decrease of $10.7 million, $4.1 million and $1.6 million, respectively, for the years ended December 31, 2004, 2003 and 2002. The net effects on income before income taxes related to these restatements were a decrease of $8.8 million, $3.7 million and $0.9 million, respectively, for the years ended December 31, 2004, 2003 and 2002. The effects on net income for the periods ended December 31, 2004, 2003 and 2002 were a decrease of $5.3 million, $1.8 million and $0.9 million, respectively. Refer to Note 13 of notes to consolidated financial statements for additional information.

(3) For the years ended December 31, 2005 and 2002, we incurred a charge for acquired in-process research and development of $13.0 million and $0.1 million, respectively.

(4) As disclosed under Explanatory Note Restatements of Financial Information immediately preceding Part I, Item 1 of this Annual Report on Form 10-K, we have restated certain financial data as of December 31, 2004, 2003 and 2002. The effects on total assets were an increase of $6.5 million, $2.2 million and $0.2 million, as of December 31, 2004, 2003 and 2002, respectively. The effects on shareholders equity were a decrease of $7.9 million, $2.7 million and $0.9 million as of December 31, 2004, 2003 and 2002, respectively.

Item 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The discussion below contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act, and Section 21E of the Exchange Act. We have used words such as believes, intends, anticipates, expects and similar expressions which are intended to identify forward-looking statements. These statements are based on information currently available to us and are subject to a number of risks and uncertainties that may cause our actual growth, results of operations, financial condition, cash flows, performance, business

prospects and opportunities and the timing of certain events to differ materially from those expressed in, or implied by, these statements. These risks, uncertainties and other factors include, without limitation, those matters discussed in Item 1A Risk Factors in Part I of this Annual Report on Form 10-K. Except as expressly required by the federal securities laws, we undertake no obligation to update such factors or to publicly announce the results of any of the forward-looking statements contained herein to reflect future events, developments, or changed circumstances, or for any other reason. The following discussion should be read in conjunction with the consolidated financial statements and notes thereto appearing elsewhere in this report, as well as consolidated financial statements and notes thereto and related management discussion and analysis of financial conditions and results of operations included in our Quarterly Report on Form 10-Q for the quarter ended March 31, 2006, which is being filed contemporaneously with this Form 10-K.

The financial data in this Annual Report on Form 10-K for the first three quarters of 2005 and for each of the quarters in 2004 has been restated from amounts previously reported to correct accounting errors. A discussion of the restatement for these quarters is provided in Note 12 to the consolidated financial statements contained in this report and under Restatement of Previously Issued Consolidated Financial Statements below. Dollars are in thousands unless otherwise noted.

Overview

Operating under the name Merge Healthcare, we develop medical imaging and information management software and deliver related services. We operate three principal sales and business development channels: Direct, which generally sells to the U.S. end-user healthcare market comprised of hospitals, imaging centers and specialty clinics; OEM and International, which primarily sells to OEMs and VARs, comprised of companies that develop, manufacture or resell medical imaging software or devices, and also to the international end user healthcare market; and eCommerce which distributes certain products through the Internet via our website. Our three-channel distribution methodology is unique in our industry. Products and services developed throughout Merge Healthcare are sold via Direct, OEM/VAR and International, and eCommerce channels worldwide. This multiple channel approach was developed to optimize the sales of the products created throughout all of Merge Healthcare, resulting in a large portfolio of solutions that can be sold in the manner that best benefits our customers, and generates both upstream and downstream revenues for us.

Healthcare providers continue to be challenged by declining reimbursements, competition and reduced operating profits brought about by the increasing costs of delivering healthcare services. In the U. S., we are focusing our direct sales efforts on single and multi-site imaging centers that complete more than 10,000 studies per year, small-to-medium sized hospitals (fewer than 400 beds), and certain specialty clinics like orthopedic practices that offer imaging services. Millennium Research Group, an international market research firm, recently reported that, in 2005, the U.S. market for RIS and PACS, consisting of RIS and enterprise, radiology, orthopedic and cardiology PACS, was valued at over $1.5 billion; that by 2010 this market will grow to over $3.0 billion, representing a compound annual growth rate of nearly 15%; and that growth for the RIS market is primarily driven by imaging centers and small hospitals, particularly those that do not already have a PACS or RIS and elect for an integrated RIS/PACS solution.

Acquisitions

We have aggressively expanded our product offerings, especially in the past four years, through our acquisitions of eFilm in 2002, RIS Logic in 2003, and more recently through our acquisition of AccuImage in January 2005, and our business combination with Cedara Software Corp. in June 2005. We acquired AccuImage for an aggregate transaction consideration of $6,978 in cash. In the case of the business combination with Cedara Software Corp., each Cedara Software Corp. share was exchanged for either 0.587 Merge common share or 0.587 exchangeable share of our wholly owned subsidiary, Merge Cedara ExchangeCo Limited, and each Cedara Software Corp. option was exchanged for an option to purchase 0.587 Merge common share with the exercise price adjusted by the U. S. dollar/Canadian dollar exchange rate as of June 1, 2005. The aggregate transaction consideration was valued at approximately $386,899. See Note 2 to our consolidated financial statements for more information about our AccuImage and RIS Logic acquisitions, as well as our business combination with Cedara Software Corp. See Part II, Item 9B, Other Information for a discussion of the impairment of goodwill associated with our business combination with Cedara Software Corp.

At the time of its acquisition, AccuImage was in the development, marketing and support of software for the advanced visualization, analysis and management of medical imaging data from medical imaging modalities. The capabilities of AccuImage have strengthened our value proposition both to our end-user and OEM/VAR customers. Similarly, at the time of our business combination with Cedara Software Corp., Cedara Software Corp. was unique among medical imaging technology companies in that it had technologies and expertise that spanned all of the major digital imaging modalities including CT, MRI, digital x-ray, mammography, ultrasound, echo-cardiology, angiography, nuclear medicine, PET and fluoroscopy. Our business combination with Cedara Software Corp. substantially increased our market penetration in the OEM/VAR medical imaging market, adding more than 200 customers that utilize Cedara Software Corp. products or services and expanded our direct end-user customer base and technology suite. As a result of the business combination, we now have an extensive imaging product suite to meet the current and emerging needs of OEM and end-user customers in radiology and multiple clinical specialties. We believe that the international presence, strong product and distribution market coverage and financial strength of the combined company will allow us to capitalize on the continued digitization of the healthcare industry.

Our expanded portfolio of technology solutions created by our strategic acquisitions allow us to cross sell existing solutions, and provide more comprehensive solutions to our customers, allowing them to adopt digital imaging technology more easily and inexpensively. In 2005, we also focused our integration efforts on forming sales and service groups with an emphasis on revenue synergies. For example, we introduced OEM clinical applications to the end-user healthcare market and to our RIS, PACS and RIS/PACS customers. In 2005, we also began to cross sell RIS and PACS solutions to existing customers, added sales professionals to our sales force and refined our sales processes and tracking mechanisms to provide real time information to manage our sales efforts.

Restatement of Previously Issued Consolidated Financial Statements

From January 10, 2006 through May 26, 2006, we received 11 anonymous letters primarily alleging improprieties relating to our financial reporting, fulfillment of customer contracts and related revenue recognition, and disclosure practices. The Audit Committee of our Board of Directors took a leadership role in assessing these matters and determining the appropriate corrective action with the assistance of outside counsel. The Audit Committee of our Board of Directors retained the independent national law firm of Sidley Austin LLP and Alvarez & Marsal, a nationally recognized forensic accounting firm, to conduct an independent investigation of the allegations contained in the anonymous letters. Sidley Austin LLP and Alvarez & Marsal conducted a comprehensive investigation of our accounting and financial reporting practices, which included, among other things, a review of relevant documents and interviews of

current and former employees of Merge Healthcare and Cedara Software Corp., which we acquired in June 2005. On May 15, 2006, Richard A. Linden, our former President and Chief Executive Officer, submitted his resignation from all positions with us and our subsidiaries, including as an officer, employee and director, and our Board of Directors accepted Mr. Linden s resignation.

On June 29, 2006, soon after Sidley Austin LLP completed its investigation, Sidley Austin LLP reported its findings to the Audit Committee, and the Audit Committee determined that, because of improper accounting and financial reporting practices with respect to reporting periods in the fiscal years 2002 through 2005, the previously issued financial statements for each of the reporting periods in 2002 through 2005 should no longer be relied upon. Furthermore, the audit reports of KPMG LLP with respect to those financial statements (including the report of KPMG with respect to management s assessment of and the effectiveness of our internal control over financial reporting) should no longer be relied upon. On June 30, 2006, the Audit Committee presented its recommendations to all of our non-employee directors. On July 2, 2006, our Board of Directors held a meeting at which it accepted the resignations of each of William C. Mortimore, our former interim Chief Executive Officer, Scott T. Veech, our former Chief Financial Officer, Treasurer and Secretary, and David M. Noshay, our former Senior Vice President, Strategic Business Development, from all positions with us and our subsidiaries, including as officers, employees and directors.

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

Revenue Recognition

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

- Delivery of certain software products to end-user customers that did not fully meet the functionality that we believe our customers expected based on express representations we made to our customers or implied representations, made to our customers that arose from our demonstrations of the software products during the sales process. We have deferred such revenue until the delivery of the expected product functionality, the majority of which occurred in the third and fourth quarters of 2005 and the second quarter of 2006.

- Collectibility was not reasonably assured at the time certain revenue was recognized. Some of our contracts failed to reflect contingencies expressly demanded by the customer. We have not recognized revenue until collectibility became reasonably assured, generally as cash was collected from the respective customer.

- Recording revenue prior to shipment of the correct products included in a customer s contract. We have deferred revenue until shipment of the appropriate products occurred.

- Recording revenue prior to shipment of all software products included in a customer s contract. Since we did not have vendor specific objective evidence of fair value for the software element of certain of our contracts, we were required to defer all revenue for certain customer orders with partial software product shipment until delivery of all software products occurred.

- For certain customers contracts, we were unable to establish vendor specific objective evidence of fair value of maintenance. We have deferred the related contract value and are recognizing revenue ratably over the related maintenance period.

- We determined that we failed to reduce net sales attributable to a contract, although we had agreed to provide the customer with $200 in additional software at no additional cost to the customer.

Income Tax Expense

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

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

Other Adjustments

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

Please refer to Note 13 of our accompanying consolidated financial statements for a discussion of the restatement of certain of our previously reported financial information, and Note 12 for a summary of the impact of the restatement on our previously reported quarterly financial information in 2004 and 2005. Please also refer to Part I, Item 1A, Risk Factors, in this Annual Report on Form 10-K for a description of the costs, risks and uncertainties related to the investigation and restatement.

We, by means of this Annual Report on Form 10-K, have restated our previously issued consolidated financial statements and financial information for each of the fiscal years ended December 31, 2004 and 2003, including unaudited interim quarterly financial statements and financial information for each of the quarters of 2004 and unaudited interim financial statements and financial information for each of the first three quarters of 2005. This filing also includes revised financial data for fiscal years ended December 31, 2002 and 2001 on an unaudited basis. We have not amended our Annual Reports on Form 10-K or Quarterly Reports on Form 10-Q for any of the affected periods. The information that has been previously filed or otherwise reported for these periods is superseded by the information contained in this Annual Report on Form 10-K, and the financial statements and related financial information contained in such reports should no longer be relied upon.

Other Recent Developments

During 2005, we focused on the following key initiatives: expanding our OEM and International channels; expanding our business development and sales distribution capabilities; expanding our RIS/PACS product features and market share; implementing strategies to enhance and strengthen the relationship with our customers, employees and shareholders, and forming strategic relationships to expand our products and services in line with emerging medical imaging market trends.

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

We continued to expand our OEM and International channel in 2005 by offering an expanded portfolio of medical imaging technologies, development platforms and products, accomplished through our business combination with Cedara Software Corp., including new clinical applications such as: Cedara I-Conference and Cedara PET/CT Workstation ; Cedara I-Response designed to

assist physicians in cancer research and treatment; the MergeCOM-3 Advanced Integrator s Native Java Tool Kit Version 3.0 utilized by OEM customers in the development of medical imaging software that requires DICOM conformance; and, Cedara B-CAD, the first CAD solution for breast ultrasound. Cedara B-CAD is currently being offered through Eastman Kodak Company to its customers worldwide as part of an integrated solution with their KODAK CARESTREAM Mammography Workstation. Our portfolio of technologies is more fully described in Part I, Item 1, Business, in this Annual Report on Form 10-K.

Through our OEM and International channel (Cedara), we entered into several strategic partnerships and ventures in new markets. In 2005, we announced a strategic partnership with i-Dent Imaging Inc. (I-Dent), pursuant to which we acquired an equity stake in i-Dent, received exclusive global rights for distribution of i-Dent s dental implant technology and agreed to work with i-Dent to develop products. We also entered into a strategic partnership with a veterinary radiology company, Eklin Medical Systems Inc. (Elkin), pursuant to which we became a 10% equity stakeholder in Eklin, and Eklin became a strategic partner to distribute our eFilm Workstation and FUSION PACS , and medical image and information management solutions. We and Eklin further agreed to exclusively co-market and co-brand our medical software solutions and to collaborate on new products for medical image and data management for the veterinary market. We also continued to deploy resources and build strategic relationships in several new markets including workflow and electronic medical records, cardiology, pathology and pharmaceutical and life sciences.

In 2005, we expanded our end-user business development and sales distribution capabilities to broaden our coverage of the North American healthcare market and to develop long-term relationships with national imaging center chains, including three of the Top Ten Medical Imaging Chains as recently acknowledged by *Medical Imaging* magazine. Our ability to understand the intricacies of business and clinical workflow within our end-user target market, especially imaging centers, has enabled us to expand our relationship with regional and national imaging center chains such as InSight Health, CDI and Regional Diagnostic, and helped us win an important new RIS/PACS software and service contract with Radiologix. In 2005, we also continued to implement end-user sales initiatives, including targeted sales and marketing activities designed to achieve broader geographic coverage, expanded presence in other healthcare vertical markets and expanded product purchases by current customers.

We expanded our U.S healthcare RIS, PACS, RIS/PACS and Clinical Applications customer base to nearly 1,000 organizations, including over 700 end-user customers and over 275 OEM/VAR customers. Use of our eFilm Workstation desktop medical imaging software increased substantially during the year, delivering strong software licensing revenues and exposing eFilm Workstation to over 60,000 clinicians and healthcare professionals worldwide. This eCommerce marketing and software distribution strategy continues to be a strong source of FUSION RIS/PACS sales leads and is intended to serve as a platform for distribution of our new advanced visualization and clinical applications.

In 2006, we have continued to develop products and services that enhance the value of our RIS/PACS foundation beyond radiology, creating clinical applications for use by the increasing number of specialists that utilize diagnostic imaging in their practices, and developing products to launch into new markets. We anticipate accelerating product innovation in partnership with our OEM customers and leveraging those relationships to strategically innovate our end-user products more rapidly to meet future customer needs.

In 2005, Congress legislated an increase (fee schedule update) of approximately 1.5% in the overall reimbursement rates for physician and outpatient services, including diagnostic imaging services. On February 8, 2006, the President signed into law the DRA, which provides that reimbursement for the technical component for imaging services (excluding diagnostic and screening mammography) in non-hospital based freestanding facilities will be capped at the lesser of reimbursement under the Medicare Part B physician fee schedule or the HOPPS schedule. The DRA also codifies the reduction in reimbursement for multiple images on contiguous body parts previously announced by the CMS. In

November 2005, CMS announced that it would pay 100% of the technical component of the higher priced imaging procedure and 50% for the technical component of each additional imaging procedure for imaging procedures involving contiguous body parts within a family of codes when performed in the same session. Under current methodology, Medicare pays 100% of the technical component of each procedure. CMS will phase in this rate reduction over two years, so that the reduction will be 25% for each additional imaging procedure in 2006 and another 25% in 2007. We believe that the implementation of the reimbursement reductions contained in the DRA will adversely impact our end-user customers revenues, and may cause some of our existing or new customers to respond by reducing their investments or postponing investment decisions, including investments in our software solutions and services.

We continue to face significant business challenges that stem from the uncertainty created by changes in our senior management, announcements regarding our inability to meet requirements of the NASDAQ Global Market for continued listing, an informal, non-public inquiry being conducted by the Securities and Exchange Commission and class action and other lawsuits. We believe that these matters have adversely affected the morale of our employees, our relationships with certain customers and potential customers and our reputation in the marketplace, and have diverted the attention of our Board of Directors and management from our business operations. We also have experienced challenges integrating the businesses and personnel of Merge Healthcare and Cedara Software Corp. In particular, we struggled to realize synergistic benefits as a consequence of organizational changes, primarily within our sales and service groups, following that business combination. See Part II, Item 9B, Other Information for a discussion of the impairment of goodwill associated with our business combination with Cedara Software Corp. In addition, since our business combination with Cedara Software Corp., we may not have devoted adequate resources to the development and acquisition of additional products. See Part I, Item 1A, Risk Factors, and Part I, Item 3, Legal Proceedings, in this Annual Report on Form 10-K for more detailed discussion regarding these matters.

Revenues and Expenses

The following is a brief discussion of our revenues and expenses:

Net Sales

Net sales consist of software and other sales, net of estimated product returns, and professional services and maintenance. Software and other sales consist of software and purchased component revenue recognized in sales to OEM customers, healthcare facilities and imaging centers. Service and maintenance consists of installation and engineering services, training, consulting, and software maintenance and support.

Cost of Sales

Cost of sales consists of purchased components, third party royalties, costs to service and support our customers, and amortization of purchased and developed software. The cost of software and other includes purchased components and third party royalties included in software and hardware sales to our customers. The cost of services and maintenance includes headcount and related costs incurred in our performance of installation and engineering services, training, consulting, and software maintenance and support. Purchased and developed software is amortized over its estimated useful life. Each quarter we test our purchased and developed software for impairment by comparing its fair value (estimated using future cash flows discounted at our cost of capital) to the carrying value of the software. If the carrying value of the software exceeds its fair value, we record an impairment charge in the period in which the impairment is incurred equal to the amount of the difference between the carrying value and discounted cash flows.

Selling and Marketing Expense

Selling and marketing expense includes the costs of sales and marketing departments, commissions and costs associated with trade shows.

Research and Development Expense

Research and development expense consists of expenses incurred for the development of our proprietary technologies, included in Part I, Item 1, Business in this Annual Report on Form 10-K. The costs reflected in this category are reduced by software development capitalized in accordance with Statement of Financial Accounting Standard (SFAS) No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*. The amortization of capitalized software development costs is included in cost of sales.

General and Administrative Expense

General and administrative expense includes costs for information systems, accounting, administrative support, management personnel, bad debt expenses and general corporate matters.

Acquired In-Process Research and Development

In connection with our acquisition of Cedara Software Corp. in 2005 (see Acquisitions above), we incurred a charge for acquired in-process research and development.

The value we assigned to acquired in-process technology was determined by identifying the acquired specific in-process research and development projects that would be continued, and for which (1) technological feasibility had not been established at the transaction date, (2) there was no alternative future use, and (3) the fair value was estimable with reasonable reliability. At the date of the business combination, Cedara Software Corp. had in-process projects meeting this definition associated with the Cedara next generation PACS workstation, OEM imaging platforms and image acquisition console projects.

The estimated fair value of the Cedara Software Corp. projects was determined by using the excess earnings approach. Appraisal assumptions utilized under this method included a forecast of estimated future net cash flows, as well as discounting the future net cash flows to their present value. We used a 20% discount rate, which was calculated using an industry beta and capital structure.

Restructuring and Other Expenses

In 2005, we incurred restructuring and other expenses consisting of the impairment of a non-cancelable building lease, which we ceased using during 2005 as we combined two of our offices located in the same geographic region, severance to involuntarily terminated employees as we combined the historic Merge and Cedara Software Corp. businesses, and option acceleration expense related to such employees. We did not incur restructuring and other expenses in 2004 or 2003.

Depreciation and Amortization

Depreciation and amortization is assessed on capital equipment, leasehold improvements and intangible assets with estimable useful lives. The amortization of capitalized software and acquired technology, which is a component of cost of sales, is excluded.

Other Income, Expense

Other income, expense is comprised of interest income earned on cash and cash equivalent balances, interest expense incurred from borrowings and foreign exchange gains or losses on foreign currency payables at Cedara Software Corp. and on foreign currency payables and receivables at our Nuenen, The Netherlands branch.

Critical Accounting Policies

Our consolidated financial statements are impacted by the accounting policies used and the estimates, judgments, and assumptions made by management during their preparation. We base our estimates and judgments on our experience, our current knowledge (including terms of existing contracts), our beliefs of what could occur in the future, our observation of trends in the industry, information provided by our customers and information available from other sources. Actual results may differ from these estimates under different assumptions or conditions.

We have identified the following accounting policies and estimates as those that we believe are most critical to our financial condition and results of operations and that require management s most subjective and complex judgments in estimating the effect of inherent uncertainties: revenue recognition, allowance for doubtful accounts, software capitalization, other long-lived assets, goodwill and intangible asset valuation, loss contingencies and income taxes.

Revenue Recognition

We derive revenues primarily from the licensing and sublicensing of software, sales of hardware and related ancillary products, installation, engineering services, training, consulting, and software maintenance and support. Inherent to software revenue recognition are significant management estimates and judgments in the interpretation and practical application of the complex rules to individual contracts. These interpretations generally would not influence the amount of revenue recognized, but could influence the timing of such revenues. Typically our contracts contain multiple elements, and while the majority of our contracts contain standard terms and conditions, there are instances where our contracts contain non-standard terms and conditions. As a result, contract interpretation is sometimes required to determine the appropriate accounting, including whether the deliverables specified in a multiple element arrangement should be treated as separate units of accounting for revenue recognition purposes in accordance with Statement of Position (SOP) No. 97-2, *Software Revenue Recognition*, or Emerging Issues Task Force (EITF) Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables*, and if so, the relative fair value that should be allocated to each of the elements as well as when to recognize revenue for each element.

For software arrangements, we recognize revenue in accordance with SOP No. 97-2. This generally requires revenue recognized on software arrangements involving multiple elements to be allocated to each element based on the vendor-specific objective evidence of fair values of those elements. Revenue from multiple-element software arrangements is recognized using the residual method, pursuant to SOP No. 98-9, *Modification of SOP No. 97-2, Software Revenue Recognition, With Respect to Certain Transactions* (SOP No. 98-9). Under the residual method, revenue is recognized in a multiple element arrangement when VSOE of fair value exists for all of the undelivered elements in the arrangement, even if vendor-specific objective evidence of fair value does not exist for one or more of the delivered elements in the arrangement, assuming all other conditions for revenue recognition have been satisfied. For sales transactions where the software is incidental, and hardware transactions where no software is involved, we recognize revenue in accordance with EITF Issue No. 00-21 and Staff Accounting Bulletin (SAB) No. 104, *Revenue Recognition*.

We allocate revenue to each undelivered element in a multiple element arrangement based on its respective 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 substantive renewal price of the maintenance offered to customers, which may be stated in the contract, or for certain customer groups using the bell-shaped curve approach. The fair value of installation, engineering services, training, and consulting is based upon the price charged when these services are sold separately. If evidence of the fair value cannot be established for undelivered elements of a sale, the entire amount of revenue under the arrangement is deferred until elements without VSOE of fair value have been delivered or VSOE of fair value can be established. If evidence of fair value cannot be established for the maintenance element of a

sale, and it represents the only undelivered element, the software, hardware, or software maintenance elements of the sale are deferred and recognized ratably over the related maintenance period.

Revenue from sublicenses sold on an individual basis and software licenses are 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 probable. We assess collectibility based on a number of factors, including past transaction history with the customer and the credit worthiness of the customer. We must exercise our judgment when we assess the probability of collection and the current creditworthiness of each customer. If the financial condition of our customers were to deteriorate, it could affect the timing and the amount of revenue we recognize on a contract. In addition, in certain transactions we may negotiate that the customer provides common stock ownership in consideration as part of the sale. We generally do not request collateral from customers.

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

Revenue from sales of RIS and from RIS/PACS solutions, where professional services are considered essential to the functionality of the solution sold, is recognized on the percentage-of-completion method, as prescribed by SOP No. 81-1, *Accounting for Performance on Construction-Type and Certain Production-Type Contracts*. Percentage of completion is determined by the input method based upon the amount of labor hours expended compared to the total estimated amount of labor hours to complete the project. Total estimated labor hours is based on management s best estimate of the total amount of time it will take to complete a project. These estimates require the use of judgment. A significant change in one or more of these estimates could affect the profitability of one or more of our contracts. We review our contract estimates periodically to assess revisions in contract values and estimated labor hours expended and reflect changes in estimates in the period that such estimates are revised under the cumulative catch-up method. At times, we have had difficulty accurately estimating the number of days required to complete the consulting and installation services and, accordingly, accurately estimating the percentages of completion.

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

For contracts accounted for under SAB No. 104, we generally invoice the customer for the final 10% of the contract value of the products delivered upon completion of hardware installation and acceptance by the customer. As a result of this specific performance obligation and acceptance criteria, we defer the related amount of product fair value and recognize it upon completion of installation and acceptance.

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

Deferred revenue is comprised of deferrals for license fees, support and maintenance, and other services. Long-term deferred revenue represents license fees, support and maintenance, and other services to be earned or provided beginning in periods on or after January 1, 2007. See Note 13 of notes to consolidated financial statements for discussion of revenue recognition matters that have lead to significant deferred revenue balances at December 31, 2005 and 2004.

We record reimbursable out-of-pocket expenses in both services and maintenance net sales and as a direct cost of services and maintenance in accordance with EITF Issue No. 01-14, *Income Statement Characterization of Reimbursements Received for Out-of-Pocket Expenses Incurred*. In accordance with EITF Issue No. 00-10, *Accounting for Shipping and Handling Fees*, the reimbursement by customers of shipping and handling costs are recorded in software and other net sales and the associated cost as a cost of sale.

Allowance for Doubtful Accounts

Based upon past experience and judgment, we establish an allowance for doubtful accounts with respect to our accounts receivable. We determine collection risk and record allowances for bad debts based on the aging of accounts and past transaction history with customers. We monitor our collections and write-off experience to assess whether adjustments to our allowance estimates are necessary. Changes in trends in any of the factors that we believe impact the realizability of our receivables, or modifications to our credit standards, collection practices, or other related policies may impact our estimate of our allowance for doubtful accounts and our financial results.

Software Capitalization

Software capitalization commences when management determines that projects have achieved technological feasibility, unless the costs expected to be incurred after achieving technological feasibility until general release are immaterial. 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 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

Other long-lived 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-lived assets whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable based primarily upon whether expected future undiscounted cash flows are sufficient to support the assets recovery. If the actual useful life of a long-lived 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 or a shorter depreciation or amortization period may be required, generally determined by a discounted cash flow analysis.

Goodwill and Other Intangible Assets

Effective January 1, 2002, we adopted SFAS No. 142, which 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 evaluate the fair value of goodwill and intangible assets using either quoted market prices or, if not available, by estimating the expected present value of their future cash flows. Identification of, and assignment of assets and liabilities to, a reporting unit require management judgment and estimates. In addition, 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. See Part II, Item 9B, Other Information for a discussion of the impairment of goodwill associated with our business combination with Cedara Software Corp.

Income Taxes

As part of the process of preparing our consolidated financial statements, we are required to estimate income taxes in each of the jurisdictions in which we operate. The provision for income taxes is determined using the asset and liability approach for accounting for income taxes in accordance with SFAS No. 109, *Accounting for Income Taxes*. A current liability is recognized for the estimated taxes payable for the current year. Deferred tax assets and liabilities are recognized for the estimated future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using the enacted tax rates in effect for the year in which the timing differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of changes in tax rates or tax laws are recognized in the provision for income taxes in the period that includes the enactment date.

Valuation allowances are established when necessary to reduce deferred tax assets to the amount more likely than not to be realized. To the extent we establish or change the valuation allowance in a period, the tax effect will flow through the statement of operations. However, in the case of deferred tax assets of an acquired or merged entity with a valuation allowance recorded for purchase accounting, any change in that valuation allowance will be recorded as an adjustment to goodwill.

The determination of our provision for income taxes requires significant judgment, the use of estimates, and the interpretation and application of complex tax laws. We are subject to income taxes in the U. S. and numerous foreign jurisdictions. Significant judgment is required in determining our worldwide provision for income taxes and recording the related tax assets and liabilities. In the ordinary course of our business, there are transactions and calculations for which the ultimate tax determination is uncertain. In spite of our belief that we have appropriate support for the all positions taken on our tax returns, we acknowledge that certain positions may be successfully challenged by the taxing authorities. Therefore, an accrual for tax contingencies is provided for, when necessary, in accordance with the requirements of SFAS No. 5, *Accounting for Contingencies*. These tax contingencies accruals are reviewed quarterly and reverse upon being sustained under audit, the expiration of the statute of limitations, new information, or other determination by the taxing authorities. The provision for income taxes includes the impact of changes in the tax contingency accrual. Although we believe our recorded tax assets and liabilities are reasonable, tax laws and regulations are subject to interpretation and inherent uncertainty; therefore our assessments can involve both a series of complex judgments about future events and rely on estimates and assumptions. Although we believe these estimates and assumptions are reasonable, the final determination could be materially different than that which is reflected in our provision for income taxes and recorded tax assets and liabilities. Due to the complexity involved, we are not able to estimate the range of possible losses in excess of amounts recorded.

In the calculation of our quarterly provision for income taxes, we use an annual effective rate based on expected annual income and statutory tax rates. The tax (or benefit) applicable to signficant unused or infrequently occurring items, discontinued operations or extraordinary items are separately recognized in the income tax provision in the quarter in which they occur.

Guarantees

Effective January 1, 2003, we adopted FASB Interpretation (FIN) No. 45, *Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (FIN No. 45). FIN No. 45 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 GAAP, 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 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.

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. However, we, Richard A. Linden, our former President and Chief Executive Officer and Scott T. Veech, our former Chief Financial Officer, are defendants in several lawsuits relating to our accounting and financial disclosure; one of these suits also names Brian E. Pedlar, former President of Cedara Software Corp. and former Senior Vice President of Merge Healthcare, who served as interim co-President and co-Chief Executive Officer from July 2, 2006 to August 18, 2006. These lawsuits and other legal matters in which we have become involved, including our receipt of a shareholder demand for derivative action, are described in Note 8 of notes to consolidated financial statements. We may be required to indemnify these individuals and advance them for their expenses in connection with such matters and therefore, may be required to accrue for such guarantees in future periods.

Loss Contingencies

We may, in the future, accrue for costs associated with certain contingencies, including, but not limited to settlement of legal proceedings and regulatory compliance matters, when such costs are probable and reasonably estimable. Liabilities established to provide for contingencies are adjusted as further information develops, circumstances change, or contingencies are resolved. See Part I, Item 3, Legal Proceedings, in this Annual Report on Form 10-K for a discussion of matters for which we may be required, in the future, to accrue costs.

Recent Accounting Pronouncements

In December 2004, the FASB issued SFAS No. 123(R), *Share-Based Payment*, to be effective for interim or annual periods beginning after September 15, 2005. On April 14, 2005, the SEC amended the compliance dates to require SFAS No. 123(R) to be effective for fiscal years beginning after September 15, 2005. SFAS No. 123(R) revises SFAS No. 123 and supersedes Accounting Principles Board Opinion No. 25 and requires all share-based payments to employees, including grants of employee stock options, to be recognized as an expense in the statement of operations. The cost will be recognized over the requisite service period based on fair values measured on the respective grant dates. We have adopted the new standard, as of January 1, 2006, using the modified prospective transition method, which permits recognition of expense on or after the effective date for the portion of outstanding awards for which the requisite service has not yet been rendered. The adoption of SFAS No. 123(R) will result in additional

expense being recorded beginning in 2006 related to our share-based employee compensation programs. We expect the adoption of SFAS No. 123(R) will have a material impact on our results of operations (see Note 1(u) to notes to consolidated financial statements).

In July 2006, FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109*, (FIN No. 48). FIN No. 48 is effective for the first interim or annual reporting period for the first fiscal year beginning on or after December 15, 2006, although earlier adoption is encouraged. FIN No. 48 applies to all tax positions for income taxes accounted for in accordance with SFAS No. 109. We are currently evaluating the impact of the adoption of FIN No. 48.

In June 2005, FASB issued SFAS No. 154, *Accounting Changes and Error Corrections*. This statement replaces APB Opinion No. 20, *Accounting Changes*, and SFAS No. 3, *Reporting Accounting Changes in Interim Financial Statements*. The statement applies to all voluntary changes in accounting for and reporting of changes in accounting principles. SFAS No. 154 requires retrospective application to prior periods financial statements of a voluntary change in accounting principles unless it is not practical to do so. APB No. 20 previously required that most voluntary changes in accounting principles be recognized by including in net income of the period of the change the cumulative effect of changing to the new accounting principle. SFAS No. 154 is effective for accounting changes made in fiscal years beginning after December 15, 2005. Earlier application is permitted for accounting changes made occurring in fiscal years beginning after May 31, 2005.

Results of Operations

(in thousands, except for share and per share data)

Year Ended December 31, 2005 Compared to Year Ended December 31, 2004

The results of operations for the year ended December 31, 2005 include those of AccuImage and Cedara Software Corp. since the date of each respective acquisition. The following table sets forth selected, unaudited consolidated financial data for the periods indicated, expressed as a percentage of net sales.

	Twelve Months Ended December 31, 2005	2004 (As restated)
Net sales	100 %	100 %
Cost of sales	31	41
Gross margin	69	59
Operating costs and expenses:		
Sales and marketing	17	27
Product research and development	12	8
General and administrative	14	18
Acquired in-process research and development	16	
Restructuring and other expenses	1	
Depreciation and amortization	4	4
Total operating costs and expenses	64	57
Operating income	5	2
Total other income, net	1	2
Income before income taxes	6	4
Income tax expense (benefit)	9	(4)
Net income (loss)	(3)%	8 %

Net Sales

The following table sets forth net sales component data for the twelve months ended December 31, 2005 and December 31, 2004:

	December 31, 2005		2004 (As restated)		% Change
Software and other	$ 60,120		$ 17,444		245 %
As a percentage of total net sales	73	%	66	%	
Service and maintenance	$ 22,481		$ 8,903		153 %
As a percentage of total net sales	27	%	34	%	
Total net sales	$ 82,601		$ 26,347		214 %

Software and other sales for 2005 was $60,120, an increase of $42,676, or 245%, from net software and other sales of $17,444 for 2004. This increase was primarily attributable to revenue recognized as a result of the inclusion of sales to Cedara OEM and end-user customers since the date of the business combination with Cedara Software Corp. As a result of this business combination, we have been able to offer an extensive imaging product suite that has allowed us to meet the current and emerging needs of OEM and end-user customers in radiology and multiple clinical specialties.

Sales from service and maintenance for 2005 were $22,481, an increase of $13,578, or 153%, from 2004 net sales of $8,903. This increase in sales from services and maintenance was primarily attributable to services performed in connection with Cedara OEM and end-user customers, while the rest of the increase was primarily attributable to the growth in sales made directly to healthcare facilities and imaging centers, where such sales are accompanied by installation services and service contracts.

Of our net sales in the twelve months ended December 31, 2005, approximately 16% and 10%, respectively, were attributable to two customers, Toshiba Medical Systems Corporation and Hitachi Medical Corporation. We anticipate that we may sign large customer contracts that may or may not have an immediate impact to our net sales. The impact to net sales in any period will depend on a number of factors, most notably whether or not we have met all the criteria for software revenue recognition and have established VSOE of fair value for the undelivered contract elements.

The following factors also affected our net sales for 2005 and 2004:

- We deferred approximately $1,800 and $10,700 for 2005 and 2004, respectively, due to current year and prior years contracts, for which the software product sold did not meet functionality we believe was expected by the customer and as to which revenue was therefore deferred into future periods.

- Net sales were reduced by approximately $1,000 related to customer contracts where collectibility was not reasonably assured at time of delivery of the software.

- Net sales for 2005 were reduced by approximately $900 for 2005 due to contracts in which we did not deliver all contract software products.

- Net sales were reduced by approximately $300 for 2005 due to contracts for which we did not have vendor specific objective evidence of fair value of maintenance.

We believe that the aggregate amount of total net sales that is recognized in the statement of operations and the net change in the deferred revenue accounts (current and long-term) on the balance sheet, could be useful indicators of the approximate value of new contracts during the period. Certain contracts, and portions of other contracts, may not be recorded as revenue or deferred revenue due to the timing in which we can invoice our customers as well as revenue recognition guidelines, including, but not

limited to, our determination of when contract collectibility is reasonably assured. The following table sets forth such data for the twelve months ended December 31, 2005 and December 31, 2004:

	December 31, 2005	2004 (As restated)
Net sales	$ 82,601	$ 26,347
Net increase in deferred revenue	$ 10,134	$ 13,742

Cost of Sales

The following table sets forth cost of sales data:

	December 31, 2005	2004 (As restated)	% Change
Software and other	$ 6,921	$ 2,302	201 %
Service and maintenance	11,106	6,108	82 %
Amortization	7,740	2,492	211 %
Total cost of sales	$ 25,767	$ 10,902	136 %

The cost of software and other for 2005 was $6,921, an increase of $4,619, or 201%, from the cost of software and other for 2004 of $2,302. Approximately $3,100 or 112%, of this increase was attributable to costs incurred as a result of the inclusion of sales to Cedara OEM and end-user customers since the date of the business combination with Cedara Software Corp. As a percentage of net software and other sales, the cost of software and other for 2005 was 12%, compared to 13% for 2004. This decrease was attributable to revenue recognized as a result of the inclusion of sales to Cedara OEM customers, which generally do not include any component costs.

The cost of services and maintenance for 2005 was $11,106, an increase of $4,998, or 82%, from the cost of services and maintenance for 2004 of $6,108. Approximately $4,228, or 85% of this increase was the result of the inclusion of costs associated with Cedara s OEM and end-user customer custom engineering, installation, engineering, training and consulting services, and maintenance and support departments. As a percentage of net service and maintenance sales, the cost of services and maintenance for 2005 was 49%, compared to 69% for 2004. The costs to provide all services to our customers were recognized as a period cost. The unusually high percentage for 2004 was attributed to our deferral of service revenue related to sales of certain software products to end-user customers that did not meet the functionality that we believe was expected by the customer.

Amortization of purchased and developed software was $7,740 for 2005, an increase of $5,248, or 211%, from amortization of $2,492 for 2004. This increase was attributable to the impairment of certain of our capitalized software projects of approximately $3,547, attributed to overlapping technologies due to the Cedara Software Corp. transaction, as well as the amortization of seven months of acquired technology associated with the Cedara Software Corp. transaction. As a percentage of total net sales, amortization of purchased and developed software was 9% of total net sales in 2005 and 2004.

Gross Margin

Gross margin was $56,834 for 2005, an increase of $41,389, or 268%, from $15,445 for 2004. As a percentage of net sales, gross margin increased to 69% of net sales for 2005 compared to 59% for 2004. The increase in gross margin as a percentage of sales was primarily due to the greater percentage of software-only sales in the twelve months ended December 31, 2005 as a result of the inclusion of OEM and international customer sales. Sales relating to our OEM customers are primarily sales of imaging software without services, which generally carry higher margins than our solutions that may also include a service or

hardware component. The relatively low percentage for 2004 was primarily attributed to our deferral of service net sales, in addition to the software and other net sales, related to sales of certain software products to end-user customers that did not meet the functionality that we believe was expected by the customer, sales in which we did not ship all software products, and sales where collectibility was not reasonably assured. The costs to provide all services to our customers were recognized as a period cost.

Sales and Marketing

Sales and marketing expense for 2005 was $13,647, an increase of $6,641, or 95%, from $7,006 for 2004, as a result of expenses incurred by the historic Cedara Software Corp. business. Sales and marketing expense for 2005 as a percentage of sales decreased to 17% compared to 27% for 2004. The relatively high percentage for 2004 was attributed to our deferral of revenue related to sales of certain software products to end-user customers that did not meet the functionality that we believe was expected by the customer.

Product Research and Development

Research and development expense for 2005 was $9,914, an increase of $7,947, or 404%, from $1,967 for 2004. As a percentage of net sales, research and development expense increased 4% from 8% for 2004 to 12% for 2005. The majority of these increases were the result of the inclusion of expenses for Cedara s OEM operations, which have a significant engineering department due to the importance of innovating software technologies in our OEM business. Capitalization of software development costs increased $142, or 4%, to $3,621 for 2005, from $3,479 for 2004.

General and Administrative

General and administrative expense for 2005 was $11,622, an increase of $6,802, or 141%, from $4,820 for 2004. The $6,802 increase was primarily attributable to the inclusion of expenses associated with Cedara s OEM and direct sales operations since the acquisition of $3,825, increased net bad debt charges during 2005 of $723 compared to $147 in 2004, and legal and accounting fees incurred subsequent to the business combination with Cedara Software Corp. General and administrative expense as a percentage of net sales decreased slightly to 14% for 2005, compared to 18% for 2004. As described in the section above captioned Restatement of Previously Issued Consolidated Financial Statements, certain of our previously issued financial statements have been restated. We have incurred, and continue to incur, substantial additional costs related to the completion of our 2005 audit and the reviews of restated periods that will be expensed in the first, second and third quarters of 2006. In addition, we may also incur substantial expenses, including substantial fees for attorneys and other professional advisors, in connection with the lawsuits and regulatory matters described in Part I, Item 3, Legal Proceedings, to this Annual Report on Form 10-K.

Acquired In-Process Research and Development

We estimated the fair value of the Cedara Software Corp. projects acquired in June 2005 to be $13,046, based on the work performed by independent valuation specialists, and recorded an expense in the consolidated statements of operations for the year ended December 31, 2005.

Restructuring and Other Expenses

We incurred $530 of restructuring and other expenses in the twelve months ended December 31, 2005, consisting of the lease exit costs associated with a non-cancelable building lease of approximately $175 which we ceased using during 2005 as we combined two of our offices located in the same geographic region, severance to involuntarily terminated employees of $263 and option acceleration expense of $92 related to such employees, based on the intrinsic value of options at the time of termination. We did not incur restructuring and other expenses in 2004. In August 2006, we settled our outstanding lease obligations with the landlord for $175.

Depreciation and Amortization

Depreciation and amortization expense for 2005 was $3,549, an increase of $2,396, or 208%, from $1,153 for 2004. Depreciation and amortization expense as a percentage was 4% in 2005 and 2004. These increases were primarily due to the $610 impairment of certain customer relationships as the result of triggering events that occurred in 2005 and amortization of customer contracts associated with the Cedara Software Corp. transaction.

Other Income, Expense

Our interest income was $1,061 in 2005, compared to $344 in 2004, while interest expense increased to $38 in 2005, compared to $21 in 2004. The interest income was directly attributable to our increased cash and cash equivalent balance, and increased interest rates on our cash balances in 2005 compared to 2004. Other expense, net, was $317 in 2005 compared to other income, net, of $146 in 2004. Net other expense for 2005 was primarily attributable to foreign exchange losses on foreign currency payables at Cedara Software Corp., where the functional currency is the U. S. Dollar. Net other income for 2004 was primarily attributable to the recovery from an insurance claim that was filed in 2003 for business interruption. As a percentage of net sales, total net other income decreased slightly to 1% for 2005 compared to 2% for 2004.

Income Taxes

We recorded income tax expense of $7,889 for 2005, an increase of $9,111, or 746%, from the benefit of $1,222 recorded for 2004. As a percentage of net sales, income tax increased to 10% expense, from a 5% benefit in 2004.

Our effective tax rate for 2005 was approximately 151%. Our effective tax rate differed from the statutory rate primarily due to the in-process research and development cost which is not deductible for income tax purposes and a $1,308 accrual associated with transaction-related legal restructuring during 2005. Excluding these two items, our 2005 effective tax rate would have been approximately 36%.

Our effective tax rate for 2004 was approximately 126%. Our effective tax rate differed from the statutory rate primarily due to an extraterritorial income tax benefit and research and experimentation credit.

Year Ended December 31, 2004 Compared to Year Ended December 31, 2003

On July 17, 2003 we acquired RIS Logic. The results of operations for 2003 include those of RIS Logic since the date of acquisition. The following table sets forth selected, unaudited consolidated financial data for the periods indicated, expressed as a percentage of net sales.

	Twelve Months Ended December 31,	
	2004 (As restated)	**2003 (As restated)**
Net sales	100 %	100 %
Cost of sales	41	33
Gross margin	59	67
Operating costs and expenses:		
Sales and marketing	27	27
Product research and development	8	8
General and administrative	18	15
Depreciation and amortization	4	4
Total operating costs and expenses	57	54
Operating income	2	13
Total other income, net	2	
Income before income taxes	4	13
Income tax expense (benefit)	(4)	(5)
Net income	8 %	18 %

Net Sales

The following table sets forth net sales component data for the twelve months ended December 31, 2004 and December 31, 2003:

	December 31, 2004 (As restated)		2003 (As restated)		% Change
Software and other	$ 17,444		$ 17,532		(1)%
As a percentage of total net sales	66	%	71	%	
Service and maintenance	$ 8,903		$ 7,028		27 %
As a percentage of total net sales	34	%	29	%	
Total net sales	$ 26,347		$ 24,560		7 %

Software and other sales for 2004 was $17,444, a decrease of $88, or 1%, from software and other sales of $17,532 for 2003. Software and other sales remained relatively consistent due to the deferral of certain sales in which we did not deliver software products to end-user customers that did not meet the functionality that we believe was expected by the customer.

Sales from service and maintenance for 2004 was $8,903, an increase of $1,875, or 27%, from 2003 net sales of $7,028. The growth of sales from the professional services group was attributed to a continued increase in the number of service contracts for customer sales in the current year and prior years pursuant to which we delivered the software product functionality contracted by the customer.

Net sales decreased by approximately $10.1 million and $3.8 million, respectively, of net sales from current year and prior years contracts for 2004 and 2003, for which the software products sold did not meet functionality we believe was expected of customer and was therefore deferred into future periods.

We believe that the aggregate amount of total net sales that is recognized in the statement of operations and the net change in the deferred revenue accounts on the balance sheet, could be useful indicators of the approximate value of new contracts during the period. Certain contracts, and portions of other contracts, may not be recorded as revenue or deferred revenue due to the timing in which we can invoice our customers as well as revenue recognition guidelines, including, but not limited to, our determination of when contract collectibility is probable. The following table sets forth such data for the twelve months ended December 31, 2004 and December 31, 2003:

	December 31, 2004 (As restated)	2003 (As restated)
Revenue	$ 26,347	$ 24,560
Net increase in deferred revenue	$ 13,742	$ 7,836

Cost of Sales

The following table sets forth cost of sales data for the twelve months ended December 31, 2004 and December 31, 2003:

	December 31, 2004 (As restated)	2003 (As restated)	% Change
Software and other	$ 2,302	$ 2,867	(20)%
Service and maintenance	6,108	3,530	73 %
Amortization	2,492	1,771	41 %
Total cost of sales	$ 10,902	$ 8,168	33 %

The cost of software and other for 2004 was $2,302, a decrease of $565 or 20% from the cost of software and other for 2003 of $2,867. This decrease was attributable to deferral of recognition of the purchased components that were included in FUSION RIS/PACS sales, and to FUSION PACS only sales during 2004 related to contracts with deferred revenue attributed to the delay in delivery of software functionality. As a percentage of net software and other sales, the cost of purchased components for 2004 was 13%, compared to 16% for 2003. We deferred software and other costs in 2004 and 2003 related to sales of certain software products to end-user customers that did not meet the functionality that we believe was expected by the customer. This cost will be recognized in the period when the delivery of the expected product functionality occurs.

The cost of professional services and maintenance was $6,108 for 2004, an increase of $2,578, or 73%, from $3,530 for 2003. As a percentage of net service and maintenance sales, the cost of professional services and maintenance for 2004 was 69%, compared to 50% for 2003. The costs to provide all services to our customers were recognized as a period cost. The relatively high percentage for 2004 was attributed to our deferral of service revenue related to sales of certain software products to end-user customers that did not meet the functionality that we believe was expected by the customer. This service and maintenance revenue will be recognized when the delivery of the expected product functionality occurs. Cost of professional services for the twelve months ended December 31, 2003 include only associated costs of RIS Logic operations since the acquisition date.

Amortization of purchased and developed software was $2,492, an increase of $721, or 41%, from $1,771 for 2003. As a percentage of total net sales, amortization of purchased and developed software for 2004 was 9%, compared to 7% for 2003. The increase in 2004 was a result of the commencement of amortization on software available for general release throughout 2004 as well as the amortization of RIS Logic-related acquired technology since the acquisition date.

Gross Margin

Gross margin was $15,445 in 2004, a decrease of $947, or 6%, from $16,392 for 2003. As a percentage of total net sales, gross margin decreased to 59% of net sales in 2004 compared to 67% for 2003. The relatively low percentage for 2004 was attributed to our deferral of service revenue, in addition to the software and other revenue, related to sales of certain software products to end-user customers that did not meet the functionality that we believe was expected by the customer. The costs to provide all services to our customers were recognized as a period cost.

Sales and Marketing

Sales and marketing expense for 2004 was $7,006, an increase of $463, or 7%, from $6,543 for 2003. The increase was the result of our objective to increase our investment in sales and marketing activities, particularly for sales team efforts in connection with sales made directly to healthcare facilities and imaging centers and an increased presence at our industry s largest tradeshow, RSNA, in late November 2004. As a percentage of net sales, sales and marketing expense for 2004 and 2003 was 27%.

Product Research and Development

Research and development expense for 2004 was $1,967, a decrease of $96, or 5%, from $2,063 for 2003. Research and development expense as a percentage of net sales was 8% in 2004 and 2003. Capitalization of software development costs increased $805, or 30%, to $3,479 in 2004, from $2,674 in 2003, as a result of our continued development of FUSION application modules and further integration of our FUSION RIS/PACS technologies during 2004. The decrease as a percentage of sales was attributable to our quality assurance efforts, which allowed us to spend a greater percentage of time on capitalizable projects.

General and Administrative

General and administrative expense for 2004 was $4,820, an increase of $1,192, or 33%, from $3,628 for 2003. As a percentage of net sales, general and administrative expense for 2004 was 18%, compared to 15% for 2003. The increase was primarily attributable to increased costs associated with our efforts to comply with the Sarbanes-Oxley Act of 2002, and to building infrastructure to support our growth.

Depreciation and Amortization

Depreciation and amortization expense for 2004 was $1,153, an increase of $305, or 36%, from $848 for 2003 as a result of fixed assets acquired from the RIS Logic acquisition being depreciated for an entire twelve months in 2004. Depreciation and amortization expense as a percentage of net sales was 4% in 2004 and 2003.

Other Income, Expense

Our interest expense increased slightly to $21 in 2004 compared to $18 in 2003, while interest income was $344 in 2004 compared to $100 in 2003. The increase in interest income was directly attributable to our increased cash and cash equivalent balances throughout 2004 compared to 2003. Net other income was $146 in 2004 compared to net other expense of $184 in 2003. The increase in net other income for 2004 was attributable to the recovery from an insurance claim filed in 2003 for business interruption and to unrealized foreign exchange gains on Euro-denominated cash held in our Netherlands branch, where the functional currency is the U. S. Dollar. Net other expense for 2003 was primarily attributable to unrealized foreign exchange losses on U. S. Dollar receivables and cash held in our Canadian subsidiary, where the functional currency was the Canadian dollar until June 2005.

Income Taxes

We recorded income tax benefit of $1,222 for 2004, a decrease of $4 from the benefit of $1,226 recorded from 2003. As a percentage of sales, income tax benefit for 2004 was 4%, compared to 5% for 2003.

Our effective tax rate for 2004 was approximately 126%. Our effective tax rate differed from the statutory rate primarily due to an extraterritorial income tax benefit and research and experimentation credit.

Our effective tax rate for 2003 was approximately (38)%. Our effective tax rate differed from the statutory rate primarily due to us benefiting from the reversal of the asset valuation allowance established against our net deferred tax asset (net operating loss carryforwards and research credits) recorded prior to 2003. Excluding this item, the 2003 effective tax rate would have been approximately 42%.

Liquidity and Capital Resources

(in thousands, except for share data)

Our cash and cash equivalents were $64,278 at December 31, 2005, an increase of $36,211 from our balance of $28,067 at December 31, 2004. In addition, our working capital, defined as the amount of our current assets that exceed our current liabilities, was $57,336 at December 31, 2005, an increase of $34,551 from our working capital of $22,785 million at December 31, 2004. At June 30, 2006, our cash and cash equivalents were $60,689.

Operating Cash Flows

Cash provided by operating activities was $23,602 in 2005, an increase of $9,690, or 70%, from $13,912 in 2004. Our positive operating cash flow in 2005 was due primarily to charges reflected in our statement of

operations that do not require cash outlay, such as stock compensation expense, provision for doubtful accounts, depreciation, amortization, in-process research and development costs and deferred income taxes totaling $33,410 and an increase in deferred revenue of $6,973, offset in part by a net loss of $2,657, an increase in accounts receivable of $5,421, a decrease of accounts payable of $3,474 and a net decrease in other assets of $5,117. The increase in accounts receivable was primarily attributable to increased sales as a result of the business combination with Cedara Software Corp. The decrease in accounts payable was primarily attributable to payment of liabilities assumed as part of the business combination with Cedara Software Corp.

Although we recorded income tax expense in 2005, the cash flow impact is expected to be less than the income tax expense in the next two years, due to tax benefits associated with utilizing net operating losses, tax credits (including losses and credits acquired in the Cedara Software Corp. transaction) and tax deductions associated with certain stock option exercises or disqualifying dispositions of Common Stock.

As described in the section above captioned Overview Restatement of Previously Issued Consolidated Financial Statements, the previously issued financial statements for each of the reporting periods in 2002 through 2005 should no longer be relied upon and required restatement. We have incurred approximately $4.3 million in costs through June 30, 2006 related to the completion of our 2005 audit and the reviews of restated quarterly periods, and continue to incur, substantial additional costs that will be expensed in the third quarter of 2006. In addition, we may also incur substantial expenses, including substantial fees for attorneys and other professional advisors, in connection with the lawsuits and regulatory matters described in Part I, Item 3, Legal Proceedings, to this Annual Report on Form 10-K. These cash payments will adversely affect our operating cash flows in 2006 and beyond.

Investing Cash Flows

Cash provided by investing activities was $3,027 in 2005, due primarily to cash acquired in acquisitions, net of cash paid, of $9,644, offset by capitalized software development costs of $3,621 and purchases of capital equipment of $2,996. We expect to continue to invest in software development projects in our effort to continue to increase sales. As part of the business combination with Cedara Software Corp., we acquired $21,639 of cash. This amount was in part offset by net cash paid in the AccuImage acquisition of $6,785 and transaction costs related to the Cedara Software Corp. transaction of $5,210 incurred by us and paid as of December 31, 2005.

Financing Cash Flows

Cash provided by financing activities was $9,572 in 2005. We received net proceeds of $9,508 from employee and director stock option exercises and $64 from purchases of Common Stock under our employee stock purchase plan.

Share Repurchase Program

On March 1, 2006, we announced that our Board had authorized us to expand our stock repurchase program to a total of $20 million of our Common Stock, from the prior authorization of $10 million. This repurchase program expired on August 24, 2006, two years after its initial implementation, without any shares having been repurchased. Our Board has not made any decision as to if or when a similar program will be implemented.

Contractual Obligations

Total outstanding commitments at December 31, 2005, were as follows:

		Payment due by period			
Contractual Obligations	**Total**	**Less than 1 Year**	**1 3 Years**	**3 5 Years**	**More than 5 Years**
Operating leases	$ 8,017	$ 2,201	$ 3,885	$ 1,781	$ 150

In April 2005, we moved to our new headquarters in Milwaukee, Wisconsin, which has approximately 22,000 square feet and is leased through April 2011. In connection with the business combination with Cedara Software Corp., we assumed lease obligations associated with a leased facility in Mississauga, Ontario, Canada, which has approximately 60,000 square feet and is leased through December 2009, and a leased facility in Burlington, Massachusetts, which has approximately 24,000 square feet and is leased through October 2008. The contractual obligations table above reflects amounts due under all leases, including the new lease in Milwaukee and leases acquired from the business combination with Cedara Software Corp. On June 1, 2006, we signed a letter exercising our right to lease an additional 14,000 square feet at our Milwaukee facility, commencing September 1, 2006 through April 2011. In August 2006, we settled our outstanding lease obligations with the landlord of a facility that we ceased using during 2005 for $175. The effects of these two events are not included in the table above.

In September 2005, we amended our unsecured revolving line of credit agreement with Lincoln State Bank, increasing our line to $35,000 from $15,000 effective September 27, 2005, and maturing September 26, 2006. The interest rate on the line of credit was at a variable rate that is equal to the prime rate as published in *The Wall Street Journal*, less 75 basis points. At December 31, 2005, the loan s interest rate was 6.5%. No amounts were outstanding on the line of credit as of December 31, 2005. As of December 31, 2005, we were in compliance with all covenants under this line of credit.

Our failure to provide Lincoln State Bank with timely annual financial statements for the year ended December 31, 2005 and interim financial statements for the quarters ended March 31, 2006 and June 30, 2006, constituted an event of default under our credit agreement. Accordingly, the obligation of Lincoln State Bank to extend us credit with respect to our $35,000 line of credit terminated. We are currently negotiating a new credit agreement with Lincoln State Bank. There can be no assurance that Lincoln State Bank or any other lender will provide us with debt financing, or that any such financing will be provided in amounts or on terms acceptable to us.

We have incurred certain costs associated with involuntarily terminated employees, which have been accrued for and included in the estimated value of liabilities assumed in conjunction with our business combination with Cedara Software Corp. At December 31, 2005, there were approximately $1,621, based on a present value using a 6% discount rate, of remaining severance payments, which will be made over a period of approximately 18 months.

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

General

We believe that our existing cash and cash equivalents and future cash flows from operations will be sufficient to otherwise meet our liquidity needs in 2006. However, any projections of future cash inflows and outflows are subject to uncertainty. In particular, our uses of cash in 2006 will depend on a variety of factors such as, potential losses from operations, the amount of cash that we are required to devote to defend and address our outstanding legal and regulatory proceedings (see Part I, Item 3, Legal Proceedings, in this Annual Report on Form 10-K), and potential merger and acquisition activities. We believe our current cash and investment balances, in addition to cash generated from operations, will be

sufficient to meet our operating, financing and capital requirements through at least the next 12 months. We also believe our cash and investment balances will be sufficient on a longer term basis; however, that will depend on numerous factors, including market acceptance of our existing and future solutions; the successful commercialization of solutions in development and costs associated with that commercialization; progress in our software development efforts; the magnitude and scope of such efforts; clinical trials and product clearance by the FDA; the successful integration of businesses that we acquire; the cost and timing of our efforts to expand our sales and marketing capabilities; and competing technological and market developments. In the event that it is necessary to raise additional capital for activities necessary to meet our short term or long term liquidity needs, such capital 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. However, these financing alternatives, including raising additional capital, may not be available in amounts or on terms acceptable to us.

Material Off Balance Sheet Arrangements

We have no material off balance sheet arrangements.

Item 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Interest Rate Risk

Our cash and cash equivalents are exposed to financial market risk due to fluctuations in interest rates, which may affect our interest income. As of December 31, 2005, our cash and cash equivalents included money market funds and short-term deposits totaling approximately $64.3 million, and earned interest at a weighted average rate of 2.8%. 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 changes in short-term interest rates. At current investment levels, our pre-tax results of operations would vary by approximately $643 for every 100 basis point change in our weighted average short-term interest rate. We do not use our portfolio for trading or other speculative purposes.

Foreign Currency Exchange Risk

We have sales and expenses in Canada, China, Japan and Europe that are denominated in currencies other than the U.S. Dollar and, as a result, have exposure to foreign currency exchange risk. We have periodically entered into forward exchange contracts to hedge exposures denominated in foreign currencies. We did not have any forward contracts outstanding at December 31, 2005. We do not enter into derivative financial instruments for trading or speculative purposes. 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 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders
Merge Technologies Incorporated:

We have audited the accompanying consolidated balance sheets of Merge Technologies Incorporated and subsidiaries (the Company) as of December 31, 2005 and 2004, and the related consolidated statements of operations, shareholders equity, comprehensive income (loss), and cash flows for each of the years in the three-year period ended December 31, 2005. These consolidated financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Merge Technologies Incorporated and subsidiaries as of December 31, 2005 and 2004, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2005, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 13 to the consolidated financial statements, the Company has restated its consolidated financial statements as of and for the year ended December 31, 2004 and for the year ended December 31, 2003.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company s internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated August 29, 2006 expressed an unqualified opinion on management s assessment of, and an adverse opinion on the effective operation of, internal control over financial reporting.

/s/ KPMG LLP
Chicago, Illinois
August 29, 2006

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

	December 31, 2005	December 31, 2004 (As restated)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 64,278	$ 28,067
Accounts receivable, net of allowance for doubtful accounts of $1,892 and $450 at December 31, 2005 and December 31, 2004, respectively	23,624	10,306
Inventory	2,440	1,082
Prepaid expenses	2,646	701
Deferred income taxes	11,213	7,310
Other current assets	3,208	4,319
Total current assets	107,409	51,785
Property and equipment:		
Computer equipment	4,025	5,275
Office equipment	1,759	755
Leasehold improvements	1,372	351
	7,156	6,381
Less accumulated depreciation	2,716	4,884
Net property and equipment	4,440	1,497
Purchased and developed software, net of accumulated amortization of $6,759 and $9,804 at December 31, 2005 and December 31, 2004, respectively	19,539	9,751
Acquired intangibles, net of accumulated amortization of $1,687 and $760 at December 31, 2005 and December 31, 2004, respectively	11,789	1,183
Goodwill	350,634	21,167
Other assets	7,862	108
Total assets	$ 501,673	$ 85,491
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 5,938	$ 2,011
Accrued wages	5,870	1,414
Income taxes payable	3,894	0
Other accrued liabilities	3,453	1,007
Deferred revenue	30,918	24,568
Total current liabilities	50,073	29,000
Deferred income taxes	3,491	868
Deferred revenue	3,784	
Other	484	
Total liabilities	57,832	29,868
Shareholders equity:		
Preferred stock, $0.01 par value: 3,999,997 shares authorized; zero shares issued and outstanding at December 31, 2005 and December 31, 2004		
Series A Preferred Stock, $0.01 par value: 1,000,000 shares authorized; zero shares issued and outstanding at December 31, 2005 and December 31, 2004		