

VITAL IMAGES INC  
Form 10-Q  
November 09, 2009  
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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-Q**

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

**For the quarterly period ended September 30, 2009**

**OR**

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

**For the transition period from      to**

**Commission File Number 0-22229**

**VITAL IMAGES, INC.**

(Exact name of registrant as specified in its charter)

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**Minnesota**  
(State or other jurisdiction of  
incorporation or organization)

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

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

**55343-4414**  
(Zip Code)

**(952) 487-9500**

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

On November 2, 2009, there were 14,300,727 shares of the Registrant's common stock, par value \$.01 per share, outstanding.



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September 30, 2009**

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Table of Contents**Part I. Financial Information****Item 1. Financial Statements****Vital Images, Inc.****Condensed Consolidated Balance Sheets****(In thousands, except per share amounts)  
(Unaudited)**

|  | September 30,<br>2009 | December 31,<br>2008 |
|--|-----------------------|----------------------|
| <b>Assets</b>  |                       |                      |
| Current assets:  |                       |                      |
| Cash and cash equivalents  | \$ 118,311            | \$ 109,706           |
| Marketable securities  | 6,683                 | 37,287               |
| Accounts receivable, net   | 12,552                | 13,047               |
| Deferred income taxes  |                       | 654                  |
| Prepaid expenses and other current assets  | 2,134                 | 2,179                |
| Total current assets   | 139,680               | 162,873              |
| Marketable securities  | 15,278                |                      |
| Property and equipment, net  | 6,168                 | 11,519               |
| Deferred income taxes  |                       | 13,904               |
| Other intangible assets, net   | 472                   | 808                  |
| Goodwill   | 9,089                 | 9,089                |
| Total assets   | \$ 170,687            | \$ 198,193           |
| <b>Liabilities and Stockholders Equity</b>   |                       |                      |
| Current liabilities:   |                       |                      |
| Accounts payable   | \$ 2,710              | \$ 3,792             |
| Accrued compensation   | 2,741                 | 2,936                |
| Accrued royalties  | 621                   | 1,057                |
| Other current liabilities  | 2,095                 | 1,947                |
| Deferred revenue   | 14,972                | 17,724               |
| Total current liabilities  | 23,139                | 27,456               |
| Deferred revenue   | 862                   | 1,164                |
| Deferred rent  | 572                   | 882                  |
| Total liabilities  | 24,573                | 29,502               |
| Commitments and contingencies (Note 12)  |                       |                      |
| Stockholders equity:   |                       |                      |
| Preferred stock: \$0.01 par value; 5,000 shares authorized; none issued or outstanding   |                       |                      |
| Common stock: \$0.01 par value; 40,000 shares authorized; 14,291 issued and outstanding as of September 30, 2009; and 14,673 shares issued and outstanding as of December 31, 2008 |                       |                      |
|  | 143                   | 147                  |
| Additional paid-in capital   | 166,806               | 168,738              |
| Accumulated deficit  | (21,002)              | (380)                |

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|  |            |            |
|--|------------|------------|
| Accumulated other comprehensive income     | 167        | 186        |
| Total stockholders' equity                 | 146,114    | 168,691    |
| Total liabilities and stockholders' equity | \$ 170,687 | \$ 198,193 |

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

Table of Contents**Vital Images, Inc.****Condensed Consolidated Statements of Operations****(In thousands, except per share amounts)  
(Unaudited)**

|   | For the Three Months Ended<br>September 30, |                  | For the Nine Months Ended<br>September 30, |                   |
|---|---|------------------|--|-------------------|
|   | 2009  | 2008             | 2009                                       | 2008              |
| <b>Revenue:</b>   |   |                  |  |                   |
| License fees  | \$ 5,624                                    | \$ 9,114         | \$ 16,183                                  | \$ 26,178         |
| Maintenance and services  | 8,274                                       | 8,157            | 25,206                                     | 23,502            |
| Hardware  | 402   | 408              | 1,074                                      | 1,023             |
| <b>Total revenue</b>  | <b>14,300</b>                               | <b>17,679</b>    | <b>42,463</b>                              | <b>50,703</b>     |
| <b>Cost of revenue:</b>   |   |                  |  |                   |
| License fees  | 749   | 1,181            | 2,277                                      | 3,345             |
| Maintenance and services  | 2,351                                       | 2,561            | 6,996                                      | 7,612             |
| Hardware  | 364   | 318              | 997  | 624               |
| <b>Total cost of revenue</b>  | <b>3,464</b>                                | <b>4,060</b>     | <b>10,270</b>                              | <b>11,581</b>     |
| <b>Gross profit</b>   | <b>10,836</b>                               | <b>13,619</b>    | <b>32,193</b>                              | <b>39,122</b>     |
| <b>Operating expenses:</b>  |   |                  |  |                   |
| Sales and marketing   | 5,200                                       | 6,298            | 16,127                                     | 21,207            |
| Research and development  | 4,245                                       | 5,422            | 12,200                                     | 15,738            |
| General and administrative  | 2,405                                       | 3,348            | 7,645                                      | 9,935             |
| Asset impairment (Note 4)   |   |                  | 3,147                                      |                   |
| <b>Total operating expenses</b>   | <b>11,850</b>                               | <b>15,068</b>    | <b>39,119</b>                              | <b>46,880</b>     |
| <b>Operating loss</b>   | <b>(1,014)</b>                              | <b>(1,449)</b>   | <b>(6,926)</b>                             | <b>(7,758)</b>    |
| Interest income   | 200   | 1,012            | 960  | 3,856             |
| Loss before income taxes  | (814)                                       | (437)            | (5,966)                                    | (3,902)           |
| Provision (benefit) for income taxes                                      | (64)  | (194)            | 14,656                                     | (1,488)           |
| <b>Net loss</b>   | <b>\$ (750)</b>                             | <b>\$ (243)</b>  | <b>\$ (20,622)</b>                         | <b>\$ (2,414)</b> |
| <b>Net loss per share - basic and diluted</b>                             | <b>\$ (0.05)</b>                            | <b>\$ (0.02)</b> | <b>\$ (1.44)</b>                           | <b>\$ (0.15)</b>  |
| <b>Weighted average common shares outstanding -<br/>basic and diluted</b> | <b>14,204</b>                               | <b>15,711</b>    | <b>14,336</b>                              | <b>16,535</b>     |

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



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## Vital Images, Inc.

## Condensed Consolidated Statements of Cash Flows

(In thousands)  
(Unaudited)

|   | For the Nine Months Ended<br>September 30, |            |
|---|--|------------|
|   | 2009                                       | 2008       |
| Cash flows from operating activities:   |  |            |
| Net loss  | \$ (20,622)                                | \$ (2,414) |
| Adjustments to reconcile net loss to net cash provided by operating activities: |  |            |
| Depreciation and amortization of property and equipment                         | 3,747                                      | 3,679      |
| Amortization of identified intangibles  | 336  | 783        |
| Loss on disposal of assets  | 112  |            |
| Asset impairment (Note 4)   | 3,147                                      |            |
| Provision for doubtful accounts   | 141  | 391        |
| Deferred income taxes   | 14,664                                     | (1,488)    |
| Excess tax benefit from stock transactions                                      |  | (317)      |
| Amortization of discount and accretion of premium on marketable securities      | 241  | (538)      |
| Employee stock-based compensation   | 2,926                                      | 3,864      |
| Amortization of deferred rent   | (296)                                      | (280)      |
| Changes in operating assets and liabilities:                                    |  |            |
| Accounts receivable   | 354  | 1,168      |
| Prepaid expenses and other assets   | 45   | (282)      |
| Accounts payable  | (793)                                      | 349        |
| Accrued expenses and other liabilities  | (596)                                      | 584        |
| Deferred revenue  | (3,054)                                    | 835        |
| Net cash provided by operating activities                                       | 352  | 6,334      |
| Cash flows from investing activities:   |  |            |
| Purchases of property and equipment   | (1,944)                                    | (3,994)    |
| Purchases of marketable securities  | (21,749)                                   | (76,313)   |
| Proceeds from maturities of marketable securities                               | 36,709                                     | 48,857     |
| Proceeds from sale of marketable securities                                     |  | 1,581      |
| Net cash provided by (used in) investing activities                             | 13,016                                     | (29,869)   |
| Cash flows from financing activities:   |  |            |
| Repurchases of common stock   | (6,081)                                    | (25,383)   |
| Proceeds from sale of common stock under stock plans                            | 1,318                                      | 1,713      |
| Excess tax benefit from stock transactions                                      |  | 317        |
| Net cash used in financing activities   | (4,763)                                    | (23,353)   |
| Net increase (decrease) in cash and cash equivalents                            | 8,605                                      | (46,888)   |
| Cash and cash equivalents, beginning of period                                  | 109,706                                    | 146,685    |
| Cash and cash equivalents, end of period  | \$ 118,311                                 | \$ 99,797  |

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



Table of Contents**Vital Images, Inc.****Notes to Condensed Consolidated Financial Statements (Unaudited)****1. Basis of presentation**

The accompanying unaudited Condensed Consolidated Financial Statements of Vital Images, Inc. (the Company) have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and notes required by accounting principles generally accepted in the United States of America. In the opinion of management, all adjustments, consisting only of normal recurring adjustments, for a fair statement have been included. Operating results for the three and nine months ended September 30, 2009 are not necessarily indicative of the results that may be expected for any subsequent quarter or for the year ending December 31, 2009. The December 31, 2008 condensed consolidated balance sheet information was derived from audited financial statements but does not include all disclosures required by accounting principles generally accepted in the United States of America. These financial statements should be read in conjunction with the financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2008.

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

The Company has evaluated subsequent events through the date the financial statements were issued, November 9, 2009.

Certain reclassifications have been made to prior period operating expense amounts in order to conform to the current period presentation. Specifically, expenses related to certain product development related activities were reclassified from general and administrative expense and sales and marketing expense to research and development expense and therefore had no effect on previously reported stockholder's equity, net loss, or net cash flows.

Operating expenses for the three and nine months ended September 30, 2008 as reported and as reclassified were as follows:

|                          | For the Three Months Ended<br>September 30, 2008 |                 | For the Nine Months Ended<br>September 30, 2008 |                 |
|--------------------------|--|-----------------|---|-----------------|
|                          | As Reported                                      | As Reclassified | As Reported                                     | As Reclassified |
| Operating expenses:      |  |                 |   |                 |
| Sales and marketing      | \$ 6,962   | \$ 6,298        | \$ 23,130                                       | \$ 21,207       |
| Research and development | 4,566  | 5,422           | 13,229  | 15,738          |

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|                            |    |        |    |        |    |        |    |        |
|----------------------------|----|--------|----|--------|----|--------|----|--------|
| General and administrative |    | 3,540  |    | 3,348  |    | 10,521 |    | 9,935  |
| Total operating expenses   | \$ | 15,068 | \$ | 15,068 | \$ | 46,880 | \$ | 46,880 |

Table of Contents**2. Significant customers and geographic data**

Significant customer revenue (dollars in thousands):

|                                     | For the Three Months Ended<br>September 30, |          |           |           | For the Nine Months Ended<br>September 30, |      |      |      |
|-------------------------------------|---|----------|-----------|-----------|--|------|------|------|
|                                     | 2009  | 2008     | 2009      | 2008      | 2009                                       | 2008 | 2009 | 2008 |
| Toshiba Medical Systems Corporation | \$ 7,979                                    | \$ 9,789 | \$ 23,761 | \$ 26,455 |  |      |      |      |
| Percentage of total revenue         | 56%   | 55%      | 56%       | 52%       |  |      |      |      |

As of September 30, 2009 and December 31, 2008, Toshiba Medical Systems Corporation ( Toshiba ) accounted for 62% and 42% of accounts receivable, respectively. As of September 30, 2009 and December 31, 2008, McKesson Information Solutions LLC accounted for 16% and 7% of accounts receivable, respectively.

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

|  | For the Three Months Ended<br>September 30, |           |           |           | For the Nine Months Ended<br>September 30, |      |      |      |
|--|---|-----------|-----------|-----------|--|------|------|------|
|  | 2009  | 2008      | 2009      | 2008      | 2009                                       | 2008 | 2009 | 2008 |
| United States                                | \$ 9,516                                    | \$ 11,996 | \$ 28,195 | \$ 37,207 |  |      |      |      |
| Europe                                       | 2,584                                       | 3,475     | 7,599     | 7,436     |  |      |      |      |
| Asia and Pacific                             | 1,279                                       | 1,213     | 3,422     | 3,162     |  |      |      |      |
| Other foreign                                | 921   | 995       | 3,247     | 2,898     |  |      |      |      |
| Total  | \$ 14,300                                   | \$ 17,679 | \$ 42,463 | \$ 50,703 |  |      |      |      |
| Export revenue as a percent of total revenue | 33%   | 32%       | 34%       | 27%       |  |      |      |      |

The Company's export sales are primarily negotiated, invoiced and paid in U.S. dollars, with a portion of sales transactions denominated in foreign currencies.

**3. Research and development**

In January 2009, the Company and Toshiba entered into a development agreement under which Toshiba provides funding in support of the Company's research and development efforts, and the parties work collaboratively to develop and deliver innovative technology advancements for Toshiba's medical equipment and the Company's advanced visualization software solutions. Software developed under the agreement is owned by the Company, and intellectual property in either party's possession that may be useful in the development efforts or that is produced during the development activities is subject to cross-licenses. For payments received under the agreement, the Company's policy is to offset research and development expense in the period in which the related costs are incurred. The agreement does not provide for recourse of payments previously offset against incurred expenses. The Company received payments of \$1,024,000 during the nine months ended September 30, 2009, and recognized credits of \$263,000 and \$768,000 during the three and nine months ended September 30, 2009,

respectively, to its research and development expense for reimbursement from Toshiba to offset the development costs the Company incurred during the respective periods under the agreement. The remaining unrecognized balance of \$256,000 was included in other current liabilities as of September 30, 2009 and will be recognized as a credit to research and development expense in future periods as the development costs are incurred.

#### **4. Asset impairment**

In 2007, the Company began the implementation of an enterprise resource planning ( ERP ) system. Phase 1 of the implementation, which related to the replacement of the Company s general ledger, was completed in 2007. The related capitalized costs are being depreciated over seven years and, as of September 30, 2009, the net book value of Phase 1 was \$659,000. Phase 2 of the implementation, which consisted of replacing the Company s various customer relationship management and order processing systems, was put on hold in 2008 in conjunction with the Company s cost-control efforts, and the Company has not capitalized any costs relating to Phase 2 since that time.

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During the three months ended June 30, 2009, the Company determined, in conjunction with continued cost-control measures, that it would not implement Phase 2. As a result, during the three months ended June 30, 2009, the Company recognized an asset impairment charge of \$3.1 million related to the costs that had been capitalized for the Phase 2 implementation.

## 5. Equity-based compensation

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

|  | For the Three Months Ended<br>September 30, |          | For the Nine Months Ended<br>September 30, |          |
|--|---|----------|--|----------|
|  | 2009  | 2008     | 2009                                       | 2008     |
| Cost of revenue                            | \$ 84                                       | \$ 86    | \$ 245                                     | \$ 250   |
| Sales and marketing                        | 316   | 321      | 940  | 976      |
| Research and development                   | 233   | 332      | 698  | 971      |
| General and administrative                 | 319   | 583      | 1,043                                      | 1,667    |
| Total equity-based compensation<br>expense | \$ 952                                      | \$ 1,322 | \$ 2,926                                   | \$ 3,864 |

As of September 30, 2009, approximately \$6.3 million of unrecognized compensation expense related to stock options was expected to be recognized over a weighted-average period of 2.8 years. As of September 30, 2009, approximately \$513,000 of unrecognized compensation expense related to restricted stock awards was expected to be recognized over a weighted-average period of 3.0 years.

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

For purposes of calculating the fair value of options under applicable accounting standards, the weighted-average fair value of options granted was \$4.67 and \$3.73, respectively, for the three and nine months ended September 30, 2009 and \$5.66 and \$5.67 for the three and nine months ended September 30, 2008, respectively. The weighted-average fair values for the options were based on the fair values on the dates of grant. The fair values for the options were calculated using the Black-Scholes option-pricing model, with the following weighted-average assumptions and expense adjusted using the following expected forfeiture rate assumptions:

|                            | For the Three Months Ended<br>September 30, |            | For the Nine Months Ended<br>September 30, |            |
|----------------------------|---|------------|--|------------|
|                            | 2009  | 2008       | 2009                                       | 2008       |
| Expected option life       | 3.75 years                                  | 3.75 years | 3.69 years                                 | 3.75 years |
| Expected volatility factor | 49%   | 45%        | 49%  | 46%        |
| Expected dividend yield    | 0%  | 0%         | 0%   | 0%         |
| Risk-free interest rate    | 2.05%                                       | 2.88%      | 1.67%                                      | 2.49%      |
| Expected forfeiture rate   | 2%  | 2%         | 2%   | 1%         |





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The following table summarizes stock option activity for the nine months ended September 30, 2009:

|  | <b>Shares Underlying<br/>Options</b> |
|--|--------------------------------------|
| Total outstanding as of December 31, 2008  | 2,452,859                            |
| Options granted                            | 573,220                              |
| Options exercised                          | (132,808)                            |
| Options cancelled                          | (194,101)                            |
| Total outstanding as of September 30, 2009 | 2,699,170                            |

Options granted during the nine months ended September 30, 2009 primarily consisted of the Company's annual grant to employees during the three months ended March 31, 2009 and grants to new hires for the nine months ended September 30, 2009.

In the first quarter of 2007, the Company granted shares of restricted stock with performance-based vesting to certain employees. No equity-based compensation expense for the awards was recognized for the three and nine months ended September 30, 2009, as the Company did not consider achievement of the performance metrics to be probable. The cumulative amount of the expense related to these awards not recognized as of September 30, 2009 but that may be recognized in future periods if performance metrics are met was \$196,000.

## 6. Per share data

Basic net loss per share is computed using net loss and the weighted-average number of common shares outstanding. Diluted net loss per share reflects the weighted-average number of common shares outstanding plus any potentially dilutive shares outstanding during the period. Potentially dilutive shares consist of shares issuable upon the exercise of stock options, as well as unvested restricted stock.

For the three and nine months ended September 30, 2009 and 2008, common share equivalents are not included in the diluted net loss per share calculations because they were antidilutive. Shares subject to antidilutive stock options and restricted stock awards excluded from net loss per share totaled 2.8 million for the three and nine months ended September 30, 2009 and 2.6 million for the three and nine months ended September 30, 2008.

## 7. Comprehensive income (loss)

Comprehensive income (loss) includes net income (loss) and items defined as other comprehensive income. Accounting standards require that items defined as other comprehensive income (loss), such as unrealized gains and losses on certain marketable securities, be separately classified in the financial statements. Such items are reported in the consolidated statements of stockholders' equity as comprehensive income (loss).

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

|  | For the Three Months Ended<br>September 30, |          | For the Nine Months Ended<br>September 30, |            |
|--|---|----------|--|------------|
|  | 2009  | 2008     | 2009                                       | 2008       |
| Net loss   | \$ (750)                                    | \$ (243) | \$ (20,622)                                | \$ (2,414) |
| Other comprehensive income (loss):   |   |          |  |            |
| Net change in unrealized gain or loss on<br>available-for-sale investments, net of tax | 25  | (48)     | (19)                                       | (105)      |
| Comprehensive loss   | \$ (725)                                    | \$ (291) | \$ (20,641)                                | \$ (2,519) |

Table of Contents**8. Fair value measurements**

The following table provides the assets and liabilities carried at fair value measured on a recurring basis as of September 30, 2009 and December 31, 2008 (in thousands):

|   | Total Carrying<br>Value at<br>September 30, 2009 | Fair Value Measurements at September 30, 2009 Using |   |   |
|---|--|---|---|---|
|   |  | Quoted price in<br>active markets<br>(Level 1)      | Significant other<br>observable inputs<br>(Level 2) | Significant<br>unobservable inputs<br>(Level 3) |
| Cash equivalents:                                   |  |   |   |   |
| Money market  | \$ 114,678                                       | \$ 114,678  | \$  | \$  |
| Marketable securities:                              |  |   |   |   |
| Corporate debt                                      | 16,971   | 16,927  | 44  |   |
| Government debt                                     | 4,990  | 4,990   |   |   |
| Total marketable securities                         | 21,961   | 21,917  | 44  |   |
| Total cash equivalents and<br>marketable securities | \$ 136,639                                       | \$ 136,595  | \$ 44   | \$  |

|   | Total Carrying<br>Value at<br>December 31, 2008 | Fair Value Measurements at December 31, 2008 Using |   |   |
|---|---|--|---|---|
|   |   | Quoted price in<br>active markets<br>(Level 1)     | Significant other<br>observable inputs<br>(Level 2) | Significant<br>unobservable inputs<br>(Level 3) |
| Cash equivalents:                                   |   |  |   |   |
| Money market  | \$ 108,102                                      | \$ 108,102   | \$  | \$  |
| Marketable securities:                              |   |  |   |   |
| Corporate debt                                      | 2,255   | 1,998  | 257   |   |
| Government debt                                     | 35,032  | 35,032   |   |   |
| Total marketable securities                         | 37,287  | 37,030   | 257   |   |
| Total cash equivalents and<br>marketable securities | \$ 145,389                                      | \$ 145,132   | \$ 257  | \$  |

Cash equivalents and marketable securities measured at fair value using quoted market prices are classified within Level 1 of the valuation hierarchy.

Marketable securities classified within Level 2 of the valuation hierarchy consist of an asset-backed security. The valuation of this asset-backed security is determined by reviewing quoted market prices for traded lots of the same or similar securities. This security is rated AAA and is current on scheduled pay-downs, with expected full maturity within the next 12 months. The Company did not consider this investment to be other than temporarily impaired as of September 30, 2009.

Table of Contents**9. Other intangible assets**

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

|   | September 30, 2009   |                          |                    | December 31, 2008    |                          |                    |
|---|----------------------|--------------------------|--------------------|----------------------|--------------------------|--------------------|
|   | Gross Carrying Value | Accumulated Amortization | Net Carrying Value | Gross Carrying Value | Accumulated Amortization | Net Carrying Value |
| Existing software technology                    | \$ 3,400             | \$ (3,400)               | \$                 | \$ 3,400             | \$ (3,334)               | \$ 66              |
| Patents and patent applications                 | 2,500                | (2,028)                  | 472                | 2,500                | (1,758)                  | 742                |
| Total intangible assets subject to amortization | \$ 5,900             | \$ (5,428)               | \$ 472             | \$ 5,900             | \$ (5,092)               | \$ 808             |

Intangible assets subject to amortization are amortized on a straight-line basis over the estimated period of benefit. Amortization expense related to other intangible assets was \$90,000 and \$261,000 for the three months ended September 30, 2009 and 2008, respectively, and \$336,000 and \$783,000 for the nine months ended September 30, 2009 and 2008, respectively. As of September 30, 2009, fully amortized existing software technology was still in use.

The estimated future amortization expense for identified intangible assets as of September 30, 2009 is as follows (in thousands):

|                   |    |     |
|-------------------|----|-----|
| Remainder of 2009 | \$ | 90  |
| 2010              |    | 360 |
| 2011              |    | 22  |
| Total             | \$ | 472 |

The preceding expected amortization expense is an estimate. Actual amortization expense may differ from estimates due to any additional intangible asset acquisitions, impairment of intangible assets, accelerated amortization of intangible assets and other events.

**10. Deferred revenue**

The components of deferred revenue were as follows:

|                         | September 30, 2009 | December 31, 2008 |
|-------------------------|--------------------|-------------------|
| Maintenance and support | \$ 12,635          | \$ 13,912         |
| Customer education      | 1,973              | 3,034             |
| Professional services   | 587                | 788               |

|                                       |    |          |    |          |
|---------------------------------------|----|----------|----|----------|
| Software                              |    | 92       |    | 616      |
| Hardware and other                    |    | 547      |    | 538      |
| Total deferred revenue                |    | 15,834   |    | 18,888   |
| Less current portion                  |    | (14,972) |    | (17,724) |
| Long-term portion of deferred revenue | \$ | 862      | \$ | 1,164    |

## 11. Income taxes

During the three months ended June 30, 2009, the Company established a full valuation allowance against its deferred tax assets. During the three months ended September 30, 2009, the Company recognized a tax benefit of \$64,000, which consisted of a one-time \$100,000 tax benefit related to the monetization of certain historic research and development tax credits as a result of the Housing and Economic Recovery Act of 2008, offset in part by a \$36,000 tax provision relating to foreign operations.

## 12. Commitments and contingencies

Under general contract terms, the Company often includes provisions in its software license agreements under which the Company agrees to indemnify its customers against liability and damages arising from claims of patent, copyright, trademark or trade secret infringement by the Company's software. The Company has not incurred any

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material costs as a result of this type of indemnification clause, and the Company does not maintain a product warranty liability related to such indemnification clauses.

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

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

**13. Share repurchase programs**

During 2008, the Company's Board of Directors approved a share repurchase program, which authorized open market transactions of up to \$40.0 million, including fees and expenses, of the Company's common stock. The program authorized management to repurchase shares from time to time, depending on market conditions. During the first quarter of 2009, the Company purchased 149,287 shares for \$1.8 million under the program. The Company completed the \$40.0 million share repurchase program on February 6, 2009, having repurchased an aggregate of 2.9 million shares under the program.

On March 3, 2009, the Company announced an additional share repurchase program, authorizing the repurchase of up to an additional 1.0 million shares on the open market. The Company completed stock repurchases under this program of 30,485 shares for \$323,000 during the three months ended September 30, 2009 and 412,392 shares for \$4.3 million during the nine months ended September 30, 2009, inclusive of fees and expenses.

At the time of repurchase, shares are returned to the status of authorized and unissued shares. The Company has accounted for the repurchases as constructively retired and recorded such repurchases as a reduction of common stock and additional paid-in capital.

**14. New accounting pronouncements**

In October 2009, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2009-13, *Multiple-Deliverable Revenue Arrangements - a consensus of the FASB Emerging Issues Task Force*, that provides amendments to the criteria for separating consideration in multiple-deliverable arrangements. The ASU does not apply to arrangements for which industry specific allocation and measurement guidance exists, such as long-term construction contracts and software transactions. ASU No. 2009-13 is effective for the Company beginning January 1, 2011. The Company may elect to adopt the provisions prospectively to new or materially modified arrangements beginning on the effective date or retrospectively for all periods presented. The Company does not expect that the adoption of this standard will have a material impact on the Company's consolidated financial statements.

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In October 2009, the FASB issued ASU No. 2009-14, *Certain Revenue Arrangements That Include Software Elements* a consensus of the FASB Emerging Issues Task Force, that reduces the types of transactions that fall within the current scope of software revenue recognition guidance. Existing software revenue recognition guidance requires that its provisions be applied to an entire arrangement when the sale of any products or services containing or utilizing software when the software is considered more than incidental to the product or service. The ASU also provides guidance on how to allocate transaction consideration when an arrangement contains both deliverables within the scope of software revenue guidance (software deliverables) and deliverables not within the scope of that guidance (non-software deliverables). ASU No. 2009-14 is effective for the Company beginning January 1, 2011. The Company may elect to adopt the provisions prospectively to new or materially modified arrangements beginning on the effective date or retrospectively for all periods presented. However, the Company must elect the same transition method for this guidance as that chosen for ASU No. 2009-13. The Company does not expect that the adoption of this standard will have a material impact on the Company's consolidated financial statements.

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

**Executive summary**

The financial results for Vital Images, Inc. (also referred to as we, us and our) have continued to be affected by the general decline in the U.S. economy, which has resulted in contracted capital spending by U.S. hospitals and lower interest rates on our cash and investments. Additionally, we have been impacted by weakness in the high-end computed tomography, or CT, and picture archiving and communication systems, or PACS, markets.

Revenue decreased for the three months ended September 30, 2009, compared to the same period in 2008, reflecting the markets' continued weakness. Operating expenses for the 2009 third quarter decreased as well, as we experienced lower compensation costs, compared to the same period in 2008, resulting primarily from our 11% workforce reduction in November 2008 and other cost-control measures.

- Revenue for the 2009 third quarter decreased 19% to \$14.3 million, compared to \$17.7 million for the third quarter of 2008.
- Gross margin was 76%, compared to 77% for the third quarter of 2008.
- Loss before income taxes was \$(814,000), compared to \$(437,000) for the third quarter of 2008.
- Net loss was \$(750,000), or \$(0.05) per diluted share, compared to \$(243,000) or \$(0.02) per diluted share, for the third quarter of 2008.

Revenue decreased for the nine months ended September 30, 2009, compared to the same period in 2008, reflecting the markets' continued weakness. Sales and marketing, research and development, and general and administrative expenses for the nine months ended September 30, 2009 decreased as we experienced lower compensation costs, compared to the same period in 2008, resulting primarily from our 11% workforce reduction in November 2008 and other cost-control measures.

- Revenue decreased 16% to \$42.5 million, compared to \$50.7 million for the first nine months of 2008.
- Gross margin was 76%, compared to 77% for the first nine months of 2008.



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- Loss before income taxes was \$(6.0) million, compared to \$(3.9) million for the first nine months of 2008.
- Net loss was \$(20.6) million, or \$(1.44) per diluted share, compared to \$(2.4) million, or \$(0.15) per diluted share, for the first nine months of 2008.
- Non-cash charges totaling \$18.1 million for the first nine months of 2009 consisted of a \$15.0 million valuation allowance against our deferred tax assets and a \$3.1 million write-off relating to the unimplemented portion of our enterprise resource planning system as a result of our cost-control efforts.

Total cash, cash equivalents and marketable securities were \$140.3 million as of September 30, 2009, compared to \$141.1 million as of June 30, 2009 and \$147.0 million as of December 31, 2008. Working capital (defined as current assets less current liabilities) was \$116.5 million as of September 30, 2009, an increase from \$113.9 million as of June 30, 2009 and a decrease from \$135.4 million as of December 31, 2008. The decrease in cash, cash equivalents and marketable securities during the three and nine months ended September 30, 2009 was primarily the result of repurchases of our common stock totaling \$323,000 and \$6.1 million, respectively, under our share repurchase programs, a decrease in interest earned on our marketable securities, and the timing of payment of accounts receivable, which may fluctuate in any quarter. The decrease in working capital during the nine months ended September 30, 2009 was due primarily to 2009 purchases of marketable securities totaling \$15.1 million classified as noncurrent as of September 30, 2009.

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**Overview**

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

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

**Critical accounting policies and estimates**

Our discussion and analysis of financial condition and results of operations are based upon our Condensed Consolidated Financial Statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. We have adopted various accounting policies to prepare the Condensed Consolidated Financial Statements in accordance with accounting principles generally accepted in the United States of America. The most significant accounting policies are disclosed in Note 2 to the Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended December 31, 2008. The preparation of these financial statements requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates. We continually evaluate our critical accounting policies and estimates. We discuss our critical accounting estimates in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the fiscal year ended December 31, 2008. We did not have any significant changes in our critical accounting policies or estimates since December 31, 2008.

Table of Contents**Results of Operations**

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

|                                      | For the Three Months Ended<br>September 30, |        | For the Nine Months Ended<br>September 30, |        |
|--------------------------------------|---|--------|--|--------|
|                                      | 2009  | 2008   | 2009                                       | 2008   |
| <b>Revenue:</b>                      |   |        |  |        |
| License fees                         | 39.3%                                       | 51.6%  | 38.1%                                      | 51.6%  |
| Maintenance and services             | 57.9  | 46.1   | 59.4                                       | 46.4   |
| Hardware                             | 2.8   | 2.3    | 2.5  | 2.0    |
| Total revenue                        | 100.0                                       | 100.0  | 100.0                                      | 100.0  |
| <b>Cost of revenue:</b>              |   |        |  |        |
| License fees                         | 5.2   | 6.7    | 5.4  | 6.6    |
| Maintenance and services             | 16.4  | 14.5   | 16.5                                       | 15.0   |
| Hardware                             | 2.5   | 1.8    | 2.3  | 1.2    |
| Total cost of revenue                | 24.1  | 23.0   | 24.2                                       | 22.8   |
| Gross profit                         | 75.9  | 77.0   | 75.8                                       | 77.2   |
| <b>Operating expenses:</b>           |   |        |  |        |
| Sales and marketing                  | 36.4  | 35.6   | 38.0                                       | 41.8   |
| Research and development             | 29.7  | 30.7   | 28.7                                       | 31.1   |
| General and administrative           | 16.8  | 18.9   | 18.0                                       | 19.6   |
| Asset impairment                     |   |        | 7.4  |        |
| Total operating expenses             | 82.9  | 85.2   | 92.1                                       | 92.5   |
| Operating loss                       | (7.0)                                       | (8.2)  | (16.3)                                     | (15.3) |
| Interest income                      | 1.4   | 5.7    | 2.2  | 7.6    |
| Loss before income taxes             | (5.6)                                       | (2.5)  | (14.1)                                     | (7.7)  |
| Provision (benefit) for income taxes | (0.4)                                       | (1.1)  | 34.5                                       | (2.9)  |
| Net loss                             | (5.2)%                                      | (1.4)% | (48.6)%                                    | (4.8)% |

**Revenue**

A comparison of revenue by category is as follows (dollars in thousands):

| 2009 | For the Three Months Ended<br>September 30, |        | 2009 | For the Nine Months Ended<br>September 30, |        |
|------|---|--------|------|--|--------|
|      | 2008  | Change |      | 2008                                       | Change |

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| Revenue:                 |    |        |    |        |    |         |       |    |        |    |        |    |         |       |
|--------------------------|----|--------|----|--------|----|---------|-------|----|--------|----|--------|----|---------|-------|
| License fees             | \$ | 5,624  | \$ | 9,114  | \$ | (3,490) | (38)% | \$ | 16,183 | \$ | 26,178 | \$ | (9,995) | (38)% |
| Maintenance and services |    | 8,274  |    | 8,157  |    | 117     | 1%    |    | 25,206 |    | 23,502 |    | 1,704   | 7%    |
| Hardware                 |    | 402    |    | 408    |    | (6)     | (1)%  |    | 1,074  |    | 1,023  |    | 51      | 5%    |
| Total revenue            | \$ | 14,300 | \$ | 17,679 | \$ | (3,379) | (19)% | \$ | 42,463 | \$ | 50,703 | \$ | (8,240) | (16)% |

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**License fee revenue (dollars in thousands)**

The following table sets forth information on license fee revenue by source (dollars in thousands):

|  | For the Three Months Ended |                       |                   |              | For the Nine Months Ended |                       |                   |              |  |
|--|----------------------------|-----------------------|-------------------|--------------|---------------------------|-----------------------|-------------------|--------------|--|
|  | 2009                       | September 30,<br>2008 | Change            |              | 2009                      | September 30,<br>2008 | Change            |              |  |
| <b>License fee revenue:</b>            |                            |                       |                   |              |                           |                       |                   |              |  |
| Direct and other                       |                            |                       |                   |              |                           |                       |                   |              |  |
| distributors                           | \$ 928                     | \$ 2,296              | \$ (1,368)        | (60)%        | \$ 2,633                  | \$ 8,143              | \$ (5,510)        | (68)%        |  |
| Toshiba                                | 4,696                      | 6,818                 | (2,122)           | (31)%        | 13,550                    | 18,035                | (4,485)           | (25)%        |  |
| <b>Total license fee revenue</b>       | <b>\$ 5,624</b>            | <b>\$ 9,114</b>       | <b>\$ (3,490)</b> | <b>(38)%</b> | <b>\$ 16,183</b>          | <b>\$ 26,178</b>      | <b>\$ (9,995)</b> | <b>(38)%</b> |  |
| <b>Percent of license fee revenue:</b> |                            |                       |                   |              |                           |                       |                   |              |  |
| Direct and other                       |                            |                       |                   |              |                           |                       |                   |              |  |
| distributors                           | 17%                        | 25%                   |                   |              | 16%                       | 31%                   |                   |              |  |
| Toshiba                                | 83%                        | 75%                   |                   |              | 84%                       | 69%                   |                   |              |  |
| <b>Total license fee revenue</b>       | <b>100%</b>                | <b>100%</b>           |                   |              | <b>100%</b>               | <b>100%</b>           |                   |              |  |

The decrease in license fee revenue during the three and nine months ended September 30, 2009, compared to the same periods in 2008, was driven primarily by continued pressure on hospital capital spending in the U.S.

**Maintenance and services revenue (dollars in thousands)**

|   | For the Three Months Ended |                       |               |           | For the Nine Months Ended |                       |                 |           |  |
|---|----------------------------|-----------------------|---------------|-----------|---------------------------|-----------------------|-----------------|-----------|--|
|   | 2009                       | September 30,<br>2008 | Change        |           | 2009                      | September 30,<br>2008 | Change          |           |  |
| <b>Maintenance and services revenue:</b>      |                            |                       |               |           |                           |                       |                 |           |  |
| Maintenance and support                       | \$ 7,132                   | \$ 6,741              | \$ 391        | 6%        | \$ 21,592                 | \$ 19,214             | \$ 2,378        | 12%       |  |
| Customer education                            | 875                        | 1,199                 | (324)         | (27)%     | 2,776                     | 3,454                 | (678)           | (20)%     |  |
| Professional services                         | 267                        | 217                   | 50            | 23%       | 838                       | 834                   | 4               | 0%        |  |
| <b>Total maintenance and services revenue</b> | <b>\$ 8,274</b>            | <b>\$ 8,157</b>       | <b>\$ 117</b> | <b>1%</b> | <b>\$ 25,206</b>          | <b>\$ 23,502</b>      | <b>\$ 1,704</b> | <b>7%</b> |  |

The increase in maintenance and support revenue for the three and nine months ended September 30, 2009, compared to the same periods in 2008, was due to an increase in the number of customers on maintenance contracts from new license sales. The decrease in customer education revenue for the three and nine months ended September 30, 2009, compared to the same periods in 2008, was due to the general timing of training sessions and the effect of decreased license sales. Professional services revenue increased for the three and nine months ended September 30, 2009, compared to the same period in 2008, due to the timing of services provided.



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The following table sets forth information on maintenance and services revenue by source (dollars in thousands):

|   | For the Three Months Ended |                    |          |      | For the Nine Months Ended |                    |          |     |  |
|---|----------------------------|--------------------|----------|------|---------------------------|--------------------|----------|-----|--|
|   | 2009                       | September 30, 2008 | Change   |      | 2009                      | September 30, 2008 | Change   |     |  |
| <b>Maintenance and services revenue:</b>            |                            |                    |          |      |                           |                    |          |     |  |
| Direct and other distributors                       | \$ 5,051                   | \$ 5,288           | \$ (237) | (4)% | \$ 15,338                 | \$ 15,218          | \$ 120   | 1%  |  |
| Toshiba   | 3,223                      | 2,869              | 354      | 12%  | 9,868                     | 8,284              | 1,584    | 19% |  |
| Total maintenance and services revenue              | \$ 8,274                   | \$ 8,157           | \$ 117   | 1%   | \$ 25,206                 | \$ 23,502          | \$ 1,704 | 7%  |  |
| <b>Percent of maintenance and services revenue:</b> |                            |                    |          |      |                           |                    |          |     |  |
| Direct and other distributors                       | 61%                        | 65%                |          |      | 61%                       | 65%                |          |     |  |
| Toshiba   | 39%                        | 35%                |          |      | 39%                       | 35%                |          |     |  |
| Total maintenance and services revenue              | 100%                       | 100%               |          |      | 100%                      | 100%               |          |     |  |

**Hardware revenue**

Hardware revenue decreased 2% to \$402,000 during the third quarter of 2009, compared to \$408,000 during the third quarter of 2008, and increased 5% to \$1.1 million during the first nine months of 2009, compared to \$1.0 million for the same period in 2008. We offer to sell hardware to our customers in conjunction with license sales, and fluctuations are driven by individual customer purchasing preferences. Sales of hardware systems are not core to our strategy and will fluctuate from period to period depending upon the needs and preferences of our customers.

**Cost of revenue and gross profit**

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

|                          | For the Three Months Ended |                    |            |       | For the Nine Months Ended |                    |            |       |  |
|--------------------------|----------------------------|--------------------|------------|-------|---------------------------|--------------------|------------|-------|--|
|                          | 2009                       | September 30, 2008 | Change     |       | 2009                      | September 30, 2008 | Change     |       |  |
| <b>Gross profit:</b>     |                            |                    |            |       |                           |                    |            |       |  |
| License fees             | \$ 4,875                   | \$ 7,933           | \$ (3,058) | (39)% | \$ 13,906                 | \$ 22,833          | \$ (8,927) | (39)% |  |
| Maintenance and services | 5,923                      | 5,596              | 327        | 6%    | 18,210                    | 15,890             | 2,320      | 15%   |  |
| Hardware                 | 38                         | 90                 | (52)       | (58)% | 77                        | 399                | (322)      | (81)% |  |
| Total gross profit       | \$ 10,836                  | \$ 13,619          | \$ (2,783) | (20)% | \$ 32,193                 | \$ 39,122          | \$ (6,929) | (18)% |  |
| <b>Gross margin:</b>     |                            |                    |            |       |                           |                    |            |       |  |
| License fees             | 87%                        | 87%                |            |       | 86%                       | 87%                |            |       |  |
| Maintenance and services | 72%                        | 69%                |            |       | 72%                       | 68%                |            |       |  |
| Hardware                 | 9%                         | 22%                |            |       | 7%                        | 39%                |            |       |  |

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|                    |     |     |     |     |
|--------------------|-----|-----|-----|-----|
| Total gross margin | 76% | 77% | 76% | 77% |
|--------------------|-----|-----|-----|-----|

License fee gross margins for the three and nine months ended September 30, 2009 were consistent with the same periods in 2009. Factors affecting gross margin for the three and nine months ended September 30, 2009, compared to the same periods in 2008, included decreased amortization expense, which positively impacted gross margin, and increased pricing pressure in a difficult market, which negatively impacted gross margin. For the three and nine



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months ended September 30, 2009, amortization expense included in license fee cost of revenue decreased \$171,000 and \$447,000, respectively, compared to the same periods in 2008, due to an intangible asset becoming fully amortized. Changes in sales mix also positively impacted gross margins for the three months ended September 30, 2009 and negatively impacted gross margin for the nine months ended September 30, 2009.

Maintenance and services gross margins increased for the three and nine months ended September 30, 2009, compared to the same periods in 2008, due to increased pricing on *Vitrexa Enterprise Suite* maintenance and services. The increase in gross margin for the nine months ended September 30, 2009 was also impacted by a \$552,000 benefit to maintenance and support revenue in the first quarter of 2009 arising from Toshiba billing adjustments relating to historic periods.

Hardware gross margins decreased for the three and nine months ended September 30, 2009, compared to the same periods in 2008, due to variability in pricing during the periods.

**Operating expenses**

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

|                            | Percent of Revenue for<br>the Three Months<br>Ended September 30,<br>2009 |       | Percent Change for<br>the<br>Three Months Ended<br>September 30,<br>2008 to 2009 | Percent of Revenue for<br>the Nine Months<br>Ended September 30,<br>2009 |       | Percent Change for the<br>Nine Months Ended<br>September 30,<br>2008 to 2009 |
|----------------------------|---|-------|--|--|-------|--|
| Operating expenses:        |   |       |  |  |       |  |
| Sales and marketing        | 36.4%   | 35.6% | (17)%  | 38.0%  | 41.8% | (24)%  |
| Research and development   | 29.7  | 30.7  | (22)%  | 28.7   | 31.1  | (22)%  |
| General and administrative | 16.8  | 18.9  | (28)%  | 18.0   | 19.6  | (23)%  |
| Asset impairment           |   |       | %  | 7.4  |       | 100%   |
| Total operating expenses   | 82.9%   | 85.2% | (21)%  | 92.1%  | 92.5% | (17)%  |

Table of Contents**Sales and marketing**

Sales and marketing expenses were as follows (dollars in thousands):

|                                 | <b>For the Three Months Ended September 30,</b> |                 |                   |              |
|---------------------------------|---|-----------------|-------------------|--------------|
|                                 | <b>2009</b>                                     | <b>2008</b>     | <b>Change</b>     |              |
| Salaries, benefits and bonuses  | \$ 2,185  | \$ 2,600        | \$ (415)          | (16)%        |
| Overhead and other expenses     | 1,041   | 887             | 154               | 17%          |
| Travel, meals and entertainment | 622   | 833             | (211)             | (25)%        |
| Trade shows and advertising     | 259   | 399             | (140)             | (35)%        |
| Commissions                     | 379   | 880             | (501)             | (57)%        |
| Depreciation                    | 398   | 378             | 20                | 5%           |
| Equity-based compensation       | 316   | 321             | (5)               | (2)%         |
| <b>Total</b>                    | <b>\$ 5,200</b>                                 | <b>\$ 6,298</b> | <b>\$ (1,098)</b> | <b>(17)%</b> |

|                                 | <b>For the Nine Months Ended September 30,</b> |                  |                   |              |
|---------------------------------|--|------------------|-------------------|--------------|
|                                 | <b>2009</b>                                    | <b>2008</b>      | <b>Change</b>     |              |
| Salaries, benefits and bonuses  | \$ 6,542                                       | \$ 8,554         | \$ (2,012)        | (24)%        |
| Overhead and other expenses     | 2,680  | 2,940            | (260)             | (9)%         |
| Travel, meals and entertainment | 1,901  | 2,617            | (716)             | (27)%        |
| Trade shows and advertising     | 1,484  | 1,963            | (479)             | (24)%        |
| Commissions                     | 1,307  | 3,005            | (1,698)           | (57)%        |
| Depreciation                    | 1,273  | 1,152            | 121               | 11%          |
| Equity-based compensation       | 940  | 976              | (36)              | (4)%         |
| <b>Total</b>                    | <b>\$ 16,127</b>                               | <b>\$ 21,207</b> | <b>\$ (5,080)</b> | <b>(24)%</b> |

The decrease in salaries and benefits costs for the three and nine months ended September 30, 2009, compared to the three and nine months ended September 30, 2008, resulted from decreased headcount, primarily from our 11% reduction in workforce in November 2008. The decrease in commissions expense for the three and nine months ended September 30, 2009, compared to the same periods in 2008, was due to a decreased amount of direct sales. The decrease in other expense categories for the three and nine months ended September 30, 2009 was primarily due to decreased headcount and other broad-based cost control measures. We had 71 and 81 sales and marketing personnel as of September 30, 2009 and 2008, respectively.

We will continue to manage sales and marketing expenses based on market conditions and business opportunities.

Table of Contents**Research and development**

Research and development expenses were as follows (dollars in thousands):

|                                | For the Three Months Ended September 30, |          |            | Change |  |
|--------------------------------|--|----------|------------|--------|--|
|                                | 2009                                     | 2008     |            |        |  |
| Salaries, benefits and bonuses | \$ 3,065                                 | \$ 3,340 | \$ (275)   | (8)%   |  |
| Overhead and other expenses    | 911                                      | 992      | (81)       | (8)%   |  |
| Depreciation                   | 221                                      | 262      | (41)       | (16)%  |  |
| Equity-based compensation      | 233                                      | 332      | (99)       | (30)%  |  |
| Consulting                     | 78                                       | 496      | (418)      | (84)%  |  |
| Development reimbursement      | (263)                                    |          | (263)      | 100%   |  |
| Total                          | \$ 4,245                                 | \$ 5,422 | \$ (1,177) | (22)%  |  |

|                                | For the Nine Months Ended September 30, |           |            | Change |  |
|--------------------------------|---|-----------|------------|--------|--|
|                                | 2009                                    | 2008      |            |        |  |
| Salaries, benefits and bonuses | \$ 8,930                                | \$ 10,105 | \$ (1,175) | (12)%  |  |
| Overhead and other expenses    | 2,536                                   | 2,677     | (141)      | (5)%   |  |
| Depreciation                   | 686                                     | 780       | (94)       | (12)%  |  |
| Equity-based compensation      | 698                                     | 971       | (273)      | (28)%  |  |
| Consulting                     | 118                                     | 1,205     | (1,087)    | (90)%  |  |
| Development reimbursement      | (768)                                   |           | (768)      | 100%   |  |
| Total                          | \$ 12,200                               | \$ 15,738 | \$ (3,538) | (22)%  |  |

The decrease in research and development expenses for the three and nine months ended September 30, 2009, compared to the same periods in 2008, was due to reduced headcount resulting from the November 2008 workforce reduction, lower utilization of consultants and other cost control measures. Additionally, during the 2009 first quarter, we entered into a development agreement with Toshiba, under which Toshiba provides funding in support of our research and development efforts, and the parties work collaboratively to develop and deliver innovative technology advancements for Toshiba's medical equipment and our advanced visualization software solutions. During the three and nine months ended September 30, 2009, we recognized a credit of \$263,000 and \$768,000, respectively, to our research and development expenses for reimbursement from Toshiba for development costs we incurred under the co-development agreement. We had 90 and 136 research and development personnel as of September 30, 2009 and 2008, respectively. The significant decrease in personnel as of September 30, 2009, compared to September 30, 2008, was the result of the 11% reduction in workforce in November 2008 and the termination of 20 employees in our Beijing office in August 2009 in conjunction with our decision to discontinue test and product development activities in Beijing.

We will continue to devote resources to develop applications and solutions to improve the cost, quality and accessibility of health care.

Table of Contents**General and administrative**

General and administrative expenses were as follows (dollars in thousands):

|                                     | For the Three Months Ended September 30, |       |      |       |        |       |       |
|-------------------------------------|--|-------|------|-------|--------|-------|-------|
|                                     | 2009                                     |       | 2008 |       | Change |       |       |
| Salaries, benefits and bonuses      | \$                                       | 1,071 | \$   | 1,022 | \$     | 49    | 5%    |
| Overhead and other expenses         |  | 587   |      | 927   |        | (340) | (37)% |
| Accounting, auditing and legal fees |  | 368   |      | 396   |        | (28)  | (7)%  |
| Equity-based compensation           |  | 319   |      | 583   |        | (264) | (45)% |
| Consulting                          |  | 60    |      | 420   |        | (360) | (86)% |
| Total                               | \$                                       | 2,405 | \$   | 3,348 | \$     | (943) | (28)% |

|                                     | For the Nine Months Ended September 30, |       |      |       |        |         |       |
|-------------------------------------|---|-------|------|-------|--------|---------|-------|
|                                     | 2009                                    |       | 2008 |       | Change |         |       |
| Salaries, benefits and bonuses      | \$                                      | 3,333 | \$   | 3,512 | \$     | (179)   | (5)%  |
| Overhead and other expenses         |   | 1,844 |      | 2,490 |        | (646)   | (26)% |
| Accounting, auditing and legal fees |   | 1,173 |      | 1,167 |        | 6       | 1%    |
| Equity-based compensation           |   | 1,043 |      | 1,667 |        | (624)   | (37)% |
| Consulting                          |   | 252   |      | 1,099 |        | (847)   | (77)% |
| Total                               | \$                                      | 7,645 | \$   | 9,935 | \$     | (2,290) | (23)% |

The decrease in general and administrative expenses during the three and nine months ended September 30, 2009, compared to the same periods in 2008, was due in part to a lower utilization of consultants and reduced headcount resulting from the November 2008 workforce reduction. Equity-based compensation decreased for the three and nine months ended September 30, 2009, compared to the same periods in 2008, as previously issued equity awards became fully vested and as headcount decreased. We had 40 and 48 general and administrative personnel as of September 30, 2009 and 2008, respectively.

We will continue to manage general and administrative expenses relative to changes in the business.

**Asset impairment**

In 2007, we began the implementation of an enterprise resource planning ( ERP ) system. Phase 1 of the implementation, which related to the replacement of our general ledger, was completed in 2007. The related capitalized costs are being depreciated over seven years and, as of September 30, 2009, the net book value of Phase 1 was \$659,000. Phase 2 of the implementation, which consisted of replacing our various customer relationship management and order processing systems, was put on hold in 2008 in conjunction with our cost-control efforts, and we have not capitalized any costs relating to Phase 2 since that time. During the three months ended June 30, 2009, we determined, in conjunction with continued cost-control measures, that we would not implement Phase 2. As a result, during the three months ended June 30, 2009, we recognized an asset impairment charge of \$3.1 million related to the Phase 2 implementation.

**Interest income**

We generated \$200,000 of interest income in the third quarter of 2009, compared to \$1.0 million in the third quarter of 2008, and generated \$960,000 of interest income for the first nine months of 2009, compared to \$3.9 million for the first nine months of 2008. The decrease for the three and nine months ended September 30, 2009, compared to the same periods in 2008, was primarily due to a decline in interest rates and a decrease in cash, cash equivalents and marketable securities due primarily to repurchases of our common stock under our share repurchase programs.

**Income taxes**

During the three months ended June 30, 2009, we established a full valuation allowance against our deferred tax assets. During the three months ended September 30, 2009, we recognized a tax benefit of \$64,000, which consisted of a one-time \$100,000 tax benefit related to the monetization of certain historic research and development tax

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credits as a result of the Housing and Economic Recovery Act of 2008, offset in part by a \$36,000 tax provision relating to foreign operations.

**Liquidity and capital resources**

The following table sets forth certain relevant measures of our liquidity and capital resources (in thousands):

|  | <b>September 30,<br/>2009</b> | <b>December 31,<br/>2008</b> |
|--|-------------------------------|------------------------------|
| Cash and cash equivalents                        | \$ 118,311                    | \$ 109,706                   |
| Marketable securities - current                  | 6,683                         | 37,287                       |
| Marketable securities - noncurrent               | 15,278                        |                              |
| Cash, cash equivalents and marketable securities | \$ 140,272                    | \$ 146,993                   |
| Working capital                                  | \$ 116,542                    | \$ 135,417                   |
| Debt   | \$                            | \$                           |

The decrease in our cash, cash equivalents and marketable securities as of September 30, 2009, compared to December 31, 2008, is primarily due to \$6.1 million of share repurchases in the first nine months of 2009 under our share repurchase programs. During the 2009 first quarter, we completed a \$40.0 million share repurchase program that commenced in 2008 and began a new share repurchase program, which authorizes up to an additional 1.0 million shares to be repurchased on the open market, pursuant to the parameters and conditions of a Rule 10b5-1 plan. As of September 30, 2009, up to 588,000 shares remained to be purchased under the program.

We believe our existing cash and investments will satisfy our foreseeable working capital requirements for at least the next 12 months. Additionally, we believe our liquidity and strong balance sheet enable us to execute our repurchases of common stock while still investing in our enterprise solution and marketing strategy and remaining well positioned to pursue strategic acquisitions if and when they emerge.

*Summary of Cash Flows*

A summary of cash flows is as follows (in thousands):

|                             | <b>For the Nine Months Ended<br/>September 30,</b> |             |
|-----------------------------|--|-------------|
|                             | <b>2009</b>  | <b>2008</b> |
| Cash provided by (used in): |  |             |
| Operating activities        | \$ 352   | \$ 6,334    |
| Investing activities        | 13,016   | (29,869)    |
| Financing activities        | (4,763)  | (23,353)    |

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|   |    |       |    |          |
|---|----|-------|----|----------|
| Net change in cash and cash equivalents | \$ | 8,605 | \$ | (46,888) |
|---|----|-------|----|----------|

*Operating activities*

Net cash provided by operating activities decreased \$6.0 million in the first nine months of 2009, compared to the same period in 2008, due to an \$18.2 million increase in net loss and a \$6.7 million decrease from changes in operating assets and liabilities, offset by an \$18.9 million increase in non-cash operating items. The \$6.7 million decrease in net cash from changes in operating assets and liabilities was primarily due to a \$3.9 million decrease in deferred revenue resulting from decreased sales for the third quarter of 2009, compared to the third quarter of 2008, and a \$2.3 million decrease in accounts payable, accrued expenses and other current liabilities resulting from decreased operating expenses in the third quarter of 2009, compared to the third quarter of 2008, and the timing of payments in the ordinary course of business. The increase in non-cash operating items primarily resulted from a \$14.6 million decrease in deferred tax assets due primarily to a \$15.0 million valuation allowance recorded in the second quarter of 2009 and a \$3.1 million asset impairment in the second quarter of 2009.

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*Investing activities*

Cash provided by investing activities was \$13.0 million for the first nine months of 2009, compared to cash used by investing activities of \$29.9 million for the same period in 2008.

We used \$21.7 million and \$76.3 million to purchase investments in marketable securities during the first nine months of 2009 and 2008, respectively. We realized \$36.7 million and \$48.9 million of proceeds from maturities and sales of marketable securities during the first nine months of 2009 and 2008, respectively. The marketable securities consist of U.S. government obligations, U.S. government agency obligations and corporate commercial obligations.

We used \$1.9 million and \$4.0 million for purchases of property and equipment in the first nine months of 2009 and 2008, respectively. Purchases during the nine months ended September 30, 2009 were principally to upgrade computer equipment. Purchases during the nine months ended September 30, 2008 were principally to upgrade computer equipment and implement our enterprise resource planning system. We anticipate that we will continue to purchase property and equipment in the normal course of business. The amount and timing of these purchases and the related cash outflows in future periods are difficult to predict and depend on a number of factors, including the hiring of employees and the rate of change of computer hardware.

*Financing activities*

Cash used by financing activities totaled \$4.8 million and \$23.4 million for the first nine months of 2009 and 2008, respectively. The primary use of cash was for the repurchase of \$6.1 million and \$25.4 million of our common stock under our share repurchase programs in the first nine months of 2009 and 2008, respectively.

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

Off-balance-sheet arrangements

We did not have any off-balance sheet arrangements as of September 30, 2009 or December 31, 2008.

Other purchase commitments



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We had no significant outstanding purchase orders as of September 30, 2009. We have entered into a number of technology licensing agreements that provide for the payment of royalties when we sell our products. We are not obligated for any minimum payments under such agreements.

### **Foreign currency transactions**

Our export sales are primarily negotiated, invoiced and paid in U.S. dollars, with a portion of sales transactions denominated in foreign currencies. As we expand our direct business internationally, we expect to enter into a higher percentage of sales transactions in foreign currencies and could be subject to greater gains or losses based on exchange rate fluctuations.

### **Recent accounting pronouncements**

Information regarding new accounting pronouncements is included in Note 14 to the Consolidated Financial Statements included in this Quarterly Report on Form 10-Q.

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**Cautionary Statement Regarding Forward-Looking Information**

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

*Factors that may impact forward-looking statements include, among others, our abilities to maintain the technological competitiveness of our current products, develop new products, successfully market our products, respond to competitive developments, develop and maintain partnerships with providers of complementary technologies, identify and close mergers and acquisitions, manage our costs and the challenges that may come with growth of our business, and attract and retain qualified sales, technical and management employees. We are also affected by the growth and regulation of the medical technology industry, including the acceptance of advanced visualization by hospitals, clinics, and universities, product clearances and approvals by the United States Food and Drug Administration and similar regulatory bodies outside the United States, and reimbursement and regulatory practices by Medicare, Medicaid, and private third-party payer organizations. We are also affected by other factors identified in our filings with the Securities and Exchange Commission, some of which are set forth in the section entitled Item 1A.Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2008 (and many of which we have discussed in prior filings). Although we have attempted to list comprehensively these important factors, we also wish to caution investors that other factors may prove to be important in the future in affecting our operating results. New factors emerge from time to time, and it is not possible for us to predict all of these factors, nor can we assess the impact each factor or combination of factors may have on our business.*

**Item 3. Quantitative and Qualitative Disclosures about Market Risk**

For information regarding our exposure to certain market risks, see Item 7A. Quantitative and Qualitative Disclosures About Market Risk, in our Annual Report on Form 10-K for the fiscal year ended December 31, 2008, which is hereby incorporated herein. There have been no material changes in the financial instruments or market risk exposures from the amounts and descriptions disclosed therein.

**Item 4. Controls and Procedures**

**Evaluation of disclosure controls and procedures**

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

Our management, under the supervision of and with the participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures, as defined in Rules 13a-

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15(e) and 15d-15(e) under the Exchange Act, as of the end of the period covered by this report. Based on such evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of the period covered by this report, our disclosure controls and procedures were effective at a reasonable assurance level.

**Limitations on the effectiveness of controls**

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

**Changes in internal control over financial reporting**

There were no changes in internal control over financial reporting during the quarter ended September 30, 2009 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents**Part II. Other Information****Item 1. Legal Proceedings**

None.

**Item 1A. Risk Factors**

The discussion of our business and operations included in this Quarterly Report on Form 10-Q should be read together with the risk factors described in Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2008. They describe various risks and uncertainties to which we are or may become subject. These risks and uncertainties, together with other factors described elsewhere in this report, have the potential to affect our business, financial condition, results of operations, cash flows, strategies or prospects in a material and adverse manner. New risks may emerge at any time, and we cannot predict those risks or estimate the extent to which they may affect financial performance.

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

c) The following table presents information with respect to purchases of Vital Images, Inc. common stock made during the quarter ended September 30, 2009 by us or our affiliated purchaser, as defined in Rule 10b-18(a)(3) under the Exchange Act.

| Period               | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs |
|----------------------|----------------------------------|------------------------------|--|--|
| July 1-31, 2009      | 30,485                           | \$ 10.56                     | 30,485   | 587,608  |
| August 1-31, 2009    |                                  | \$                           |  | 587,608  |
| September 1-30, 2009 | 30,485                           | \$ 10.56                     | 30,485   | 587,608  |

On May 8, 2008, we announced a share repurchase program of up to \$25.0 million of our common stock. On August 7, 2008, we announced additional repurchases of up to \$15.0 million of our common stock, allowing for total repurchases of up to \$40.0 million of our common stock under the share repurchase program. We completed this share repurchase program on February 6, 2009 through only open market transactions. On March 3, 2009, we announced a new share repurchase program, under which we may repurchase up to 1.0 million shares of our common stock. The new share repurchase program expires on February 28, 2010.

**Item 3. Defaults upon Senior Securities**

None.

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

None.

**Item 5. Other Information**

None.

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**Item 6. Exhibits**

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

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

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**Signatures**

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

Date: November 9, 2009

VITAL IMAGES, INC.

/s/ Peter J. Goepfrich  
Peter J. Goepfrich  
Chief Financial Officer

(Principal Financial Officer and  
Principal Accounting Officer)