VITAL IMAGES INC
Form 10-Q
May 10, 2010

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2010

OR

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

For the transition period from to

Commission File Number 0-22229

VITAL IMAGES, INC.

(Exact name of registrant as specified in its charter)

Minnesota (State or other jurisdiction of 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)

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

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 o No o

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 o	Accelerated filer x
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

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

On May 3, 2010, there were 14,447,388 shares of the Registrant s common stock, par value $.01 per share, outstanding.

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Part I. Financial Information

Item 1. Financial Statements

Vital Images, Inc.

Condensed Consolidated Balance Sheets

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

	March 31, 2010	December 31, 2009
Assets		
Current assets:		
Cash and cash equivalents	$ 121,121	$ 120,317
Marketable securities	14,481	9,673
Accounts receivable, net	13,068	12,196
Prepaid expenses and other current assets	2,546	2,686
Total current assets	151,216	144,872
Marketable securities	7,443	12,234
Property and equipment, net	4,785	5,485
Other intangible assets, net	292	382
Goodwill	9,089	9,089
Total assets	$ 172,825	$ 172,062
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 2,629	$ 2,588
Accrued compensation	2,264	3,574
Accrued royalties	789	812
Other current liabilities	1,684	1,364
Deferred revenue	15,764	15,500
Total current liabilities	23,130	23,838
Deferred revenue	1,087	1,033
Deferred rent	362	469
Total liabilities	24,579	25,340
Commitments and contingencies (Note 11)		
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; 14,442 issued and outstanding as of March 31, 2010; and 14,330 shares issued and outstanding as of December 31, 2009	144	143
Additional paid-in capital	170,659	168,058
Accumulated deficit	(22,724)	(21,632)
Accumulated other comprehensive income	167	153
Total stockholders equity	148,246	146,722
Total liabilities and stockholders equity	$ 172,825	$ 172,062

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

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Vital Images, Inc.

Condensed Consolidated Statements of Operations

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

	For the Three Months Ended March 31, 2010		For the Three Months Ended March 31, 2009	
Revenue:				
License fees	$	5,521	$	5,994
Maintenance and services		8,804		8,561
Hardware		434		233
Total revenue		14,759		14,788
Cost of revenue:				
License fees		917		970
Maintenance and services		2,347		2,377
Hardware		440		209
Total cost of revenue		3,704		3,556
Gross profit		11,055		11,232
Operating expenses:				
Sales and marketing		5,479		5,440
Research and development		4,030		4,002
General and administrative		2,722		2,743
Total operating expenses		12,231		12,185
Operating loss		(1,176)		(953)
Interest income		108		430
Loss before income taxes		(1,068)		(523)
Provision (benefit) for income taxes		24		(272)
Net loss	$	(1,092)	$	(251)
Net loss per share basic and diluted	$	(0.08)	$	(0.02)
Weighted average common shares outstanding basic and diluted		14,332		14,518

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 Three Months Ended March 31, 2010	For the Three Months Ended March 31, 2009
Cash flows from operating activities:		
Net loss	$ (1,092)	$ (251)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization of property and equipment	927	1,285
Amortization of identified intangibles	90	156
Provision for doubtful accounts	66	88
Deferred income taxes		(300)
Excess tax benefit from stock transactions		(58)
Amortization of discount and accretion of premium on marketable securities	(3)	90
Employee stock-based compensation (Note 4)	1,487	992
Amortization of deferred rent	(102)	(97)
Changes in operating assets and liabilities:		
Accounts receivable	(938)	2,522
Prepaid expenses and other assets	140	323
Accounts payable	44	(1,053)
Accrued expenses and other liabilities	(1,041)	(993)
Deferred revenue	318	(1,155)
Net cash (used in) provided by operating activities	(104)	1,549
Cash flows from investing activities:		
Purchases of property and equipment	(230)	(721)
Purchases of marketable securities		(11,902)
Proceeds from maturities of marketable securities		2,090
Net cash used in investing activities	(230)	(10,533)
Cash flows from financing activities:		
Repurchases of common stock		(3,249)
Proceeds from sale of common stock under stock plans	1,332	513
Payment for options tendered (Note 4)	(194)	
Excess tax benefit from stock transactions		58
Net cash provided by (used in) financing activities	1,138	(2,678)
Net increase (decrease) in cash and cash equivalents	804	(11,662)
Cash and cash equivalents, beginning of period	120,317	109,706
Cash and cash equivalents, end of period	$ 121,121	$ 98,044

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

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Vital Images, Inc.

Notes to Condensed Consolidated Financial Statements (Unaudited)

1. Basis of presentation

The accompanying unaudited Condensed Consolidated Financial Statements of Vital Images, Inc. (the Company) have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and notes required by accounting principles generally accepted in the United States of America. In the opinion of management, all adjustments, consisting only of normal recurring adjustments, for a fair statement have been included. Operating results for the three months ended March 31, 2010 are not necessarily indicative of the results that may be expected for any subsequent quarter or for the year ending December 31, 2010. The December 31, 2009 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, 2009.

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 products and 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.

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 months ended March 31, 2009 as reported and as reclassified were as follows:

	For the Three Months Ended March 31, 2009	
	As Previously Reported	**As Reclassified**
Operating expenses:		
Sales and marketing	$ 5,955	$ 5,440
Research and development	3,261	4,002
General and administrative	2,969	2,743
Total operating expenses	$ 12,185	$ 12,185

2. Significant customers and geographic data

Significant customer revenue (dollars in thousands):

	For the Three Months Ended March 31,	
	2010	2009
Toshiba Medical Systems Corporation	$ 8,220	$ 8,233
Percentage of total revenue	56%	56%

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Customers accounting for more than 10% of the Company s accounts receivable were as follows (in thousands):

	March 31, 2010	December 31, 2009
Toshiba Medical Systems Corporation	58%	36%
McKesson Information Solutions LLC	16%	14%
Medtronic Inc.	*	12%

*Less than 10%.

Sales to customers located in the following geographic areas are summarized as follows (in thousands):

	For the Three Months Ended March 31, 2010	2009
United States	$ 9,644	$ 9,684
Europe	2,681	2,663
Asia and Pacific	1,604	1,348
Other foreign	830	1,093
Total	$ 14,759	$ 14,788
Export revenue as a percent of total revenue	35%	35%

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 $481,000 during the three months ended March 31, 2010, and recognized credits of $241,000 during the three months ended March 31, 2010, to its research and development expense for reimbursement from Toshiba to offset the development costs the Company incurred during the period under the agreement. The remaining unrecognized balance of $240,000 was included in other current liabilities as of March 31, 2010 and will be recognized as an offset to research and development expense in future periods as the development costs are incurred.

4. Equity-based compensation

During the three months ended March 31, 2010, the Company initiated a cash tender offer for certain employee stock options in an effort to reduce its stock option overhang. The tender offer expired on March 19, 2010. Pursuant to the tender offer, employees tendered for purchase 360,000 options, and the Company accepted for purchase all such options. As a result, the Company paid an aggregate of $194,000 to the participating employees and incurred a equity-based compensation expense of $692,000 related to the remaining unamortized equity-based compensation expense associated with the options tendered in the offer. The tender offer applied to outstanding stock options held by employees with an exercise price equal to or greater than $25.00 per share. The price offered for each eligible stock option was at a discount to its Black-Scholes fair value.

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

	For the Three Months Ended March 31, 2010	
Cost of revenue	$	61
Sales and marketing		247
Research and development		180
General and administrative		204
Equity-based compensation expense relating to the tender offer	$	692

The following table illustrates how equity-based compensation, including the expense related to the tender offer, was allocated to the condensed consolidated statements of operations (in thousands):

	For the Three Months Ended March 31,			
	2010		2009	
Cost of revenue	$	137	$	80
Sales and marketing		430		312
Research and development		414		231
General and administrative		506		369
Total equity-based compensation expense	$	1,487	$	992

As of March 31, 2010, approximately $5.1 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 March 31, 2010, approximately $276,000 of unrecognized compensation expense related to restricted stock awards was expected to be recognized over a weighted-average period of 2.9 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 $5.84 for the three months ended March 31, 2010 and $3.34 for the three months ended March 31, 2009. The weighted-average fair values for the options were based on the fair values on the dates of grant. The fair values for the options were calculated using the Black-Scholes option-pricing model, with the following weighted-average assumptions and expense adjusted using the following expected forfeiture rate assumptions:

	For the Three Months Ended March 31,	
	2010	2009
Expected option life	3.73 years	3.75 years

Expected volatility factor	46%	48%
Expected dividend yield	0%	0%
Risk-free interest rate	1.98%	1.57%
Expected forfeiture rate	2%	2%

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The following table summarizes stock option activity for the three months ended March 31, 2010:

	Shares Underlying Options
Total outstanding as of December 31, 2009	2,639,767
Options granted	322,200
Options exercised	(122,761)
Options cancelled	(513,507)
Total outstanding as of March 31, 2010	2,325,699

Options granted during the three months ended March 31, 2010 consisted of the Company s annual grant to employees and grants to new hires for the three months ended March 31, 2010. Options cancelled during the three months ended March 31, 2010 included cancellation of options for 360,000 shares resulting from the tender offer.

The following table summarizes restricted shares activity for the three months ended March 31, 2010:

	Restricted Shares
Total outstanding as of December 31, 2009	49,123
Shares vested	(4,486)
Shares forfeited/cancelled	(17,950)
Total outstanding as of March 31, 2010	26,687

5. 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 months ended March 31, 2010 and 2009, common share equivalents are not included in the diluted net loss per share calculations because they were antidilutive due to the Company having a net loss for each of the periods. Shares subject to antidilutive stock options and restricted stock awards excluded from net loss per share totaled 2.4 million and 2.7 million for the three months ended March 31, 2010 and 2009, respectively.

6. 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).

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

	For the Three Months Ended March 31, 2010	2009
Net loss	$ (1,092)	$ (251)
Other comprehensive income (loss):		
Net change in unrealized gain or loss on available-for-sale investments, net of tax	14	(86)
Comprehensive loss	$ (1,078)	$ (337)

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7. Fair value measurements

The following table provides the assets and liabilities carried at fair value measured on a recurring basis as of March 31, 2010 and December 31, 2009 (in thousands):

	Total Carrying Value at March 31, 2010	Fair Value Measurements at March 31, 2010 Using Quoted price in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Cash equivalents:				
Money market	$ 114,965	$ 114,965	$	$
Marketable securities:				
Corporate debt	16,925	16,925		
Government debt	4,999	4,999		
Total marketable securities	21,924	21,924		
Total cash equivalents and marketable securities	$ 136,889	$ 136,889	$	$

	Total Carrying Value at December 31, 2009	Fair Value Measurements at December 31, 2009 Using Quoted price in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Cash equivalents:				
Money market	$ 114,830	$ 114,830	$	$
Marketable securities:				
Corporate debt	16,911	16,911		
Government debt	4,996	4,996		
Total marketable securities	21,907	21,907		
Total cash equivalents and marketable securities	$ 136,737	$ 136,737	$	$

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

8. Other intangible assets

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

	March 31, 2010	December 31, 2009
Gross Carrying Value	$ 2,500	$ 2,500
Accumulated Amortization	(2,208)	(2,118)

Net Carrying Value	$	292	$	382

Other intangible assets consist of patents and patent applications subject to amortization and are amortized on a straight-line basis over the estimated period of benefit. Amortization expense related to other intangible assets was $90,000 and $156,000 for the three months ended March 31, 2010 and 2009.

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The estimated future amortization expense for intangible assets as of March 31, 2010 is as follows (in thousands):

Remainder of 2010	$	270
2011		22
Total	$	292

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.

9. Deferred revenue

The components of deferred revenue were as follows:

		March 31, 2010		December 31, 2009
Maintenance and support	$	13,188	$	13,043
Customer education		2,166		2,036
Professional services		771		848
Software		276		255
Hardware and other		450		351
Total deferred revenue		16,851		16,533
Less current portion		(15,764)		(15,500)
Long-term portion of deferred revenue	$	1,087	$	1,033

10. Income taxes

As of March 31, 2010 and December 31, 2009, the Company had a full valuation allowance against its $16.8 million of deferred tax assets based on the Company s assessment of cumulative pretax results in recent years and projections of cumulative pretax results in future periods. During the three months ended March 31, 2010, the Company recognized a $24,000 provision for income taxes relating entirely to foreign income taxes. For the three months ended March 31, 2009, the Company s $272,000 benefit for income taxes consisted of federal, state and foreign income taxes. The Company s consolidated effective income tax rate for the three months ended March 31, 2009 was 52.0%, which was a composite rate of the applicable rates in the various jurisdictions and included the relative impact of research and development credits on pretax results for the three months ended March 31, 2009.

11. Commitments and contingencies

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

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

The Company is involved in various claims and legal actions in the normal course of business. 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.

12. Share repurchase program

As of the March 31, 2010, the Company had a share repurchase program in place, under which there remained 588,000 shares authorized for repurchase on the open market. No shares were repurchased during the three months ended March 31, 2010. At the time of repurchase, shares are returned to the status of authorized and unissued shares.

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The Company has accounted for repurchases as constructively retired and recorded such repurchases as a reduction of common stock and additional paid-in capital.

13. Recent 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. The Company will adopt ASU No. 2009-13 on January 1, 2011. The Company may elect to adopt the provisions prospectively for 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.

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, such as hardware). The Company will adopt ASU No. 2009-14 on January 1, 2011. The Company may elect to adopt the provisions prospectively for 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, evidenced by contracted capital spending by U.S. hospitals and lower interest rates on our cash and investments. Additionally, we have been impacted by weaknesses in the markets for high-end computed tomography, or CT, equipment and picture archiving and communication systems, or PACS. We mitigated these negative factors through significant cost-control measures, while continuing to make strategic investments.

Vital Images, Inc. summary results for the three months ended March 31, 2010, were as follows:

- Revenue for the 2010 first quarter remained flat at $14.8 million, compared to the first quarter of 2009.

- Gross margin was 74.9%, compared to 76.0% for the first quarter of 2009.

- Loss before income taxes was $1.1 million, compared to $523,000 for the first quarter of 2009.

- Net loss was $1.1 million, or $(0.08) per diluted share, which included a $692,000, or $(0.05) per diluted share, equity-based compensation charge relating to the tender offer for certain employee stock options that closed in the first quarter, compared to $251,000 or $(0.02) per diluted share, for the first quarter of 2009.

Total cash, cash equivalents and marketable securities were $143.0 million as of March 31, 2010, compared to $142.2 million as of December 31, 2009. Working capital (defined as current assets less current liabilities) was $128.1 million as of March 31, 2010, an increase from $121.0 million as of December 31, 2009. The increase in working capital during the three months ended March 31, 2010 was due primarily to noncurrent marketable securities becoming current during the three months ended March 31, 2010.

Overview

We are a leading provider of advanced visualization and analysis software for physicians and healthcare specialists. 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 physician workflow and productivity, enhance the ability to make clinical decisions, facilitate less invasive patient care, and complement often significant capital investments in diagnostic imaging equipment made by our customers. Our software is compatible with equipment from all major manufacturers of diagnostic imaging equipment, such as CT scanners, and can be integrated into 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 products and 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

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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, 2009. 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, 2009. We did not have any significant changes in our critical accounting policies or estimates since December 31, 2009.

Results of Operations

The following table sets forth information from our condensed consolidated statements of operations, expressed as a percentage of total revenue.

	For the Three Months Ended March 31,	
	2010	**2009**
Revenue:		
License fees	37.4%	40.5%
Maintenance and services	59.7	57.9
Hardware	2.9	1.6
Total revenue	100.0	100.0
Cost of revenue:		
License fees	6.2	6.5
Maintenance and services	15.9	16.1
Hardware	3.0	1.4
Total cost of revenue	25.1	24.0
Gross profit	74.9	76.0
Operating expenses:		
Sales and marketing	37.1	36.8
Research and development	27.3	27.1
General and administrative	18.4	18.5
Total operating expenses	82.8	82.4
Operating loss	(7.9)	(6.4)
Interest income	0.7	2.9
Loss before income taxes	(7.2)	(3.5)
Provision (benefit) for income taxes	0.2	(1.8)
Net loss	(7.4)%	(1.7)%

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Revenue

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

	For the Three Months Ended March 31,			
	2010	2009	Change	
Revenue:				
License fees	$ 5,521	$ 5,994	$ (473)	(8)%
Maintenance and services	8,804	8,561	243	3%
Hardware	434	233	201	86%
Total revenue	$ 14,759	$ 14,788	$ (29)	(0)%

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 March 31,			
	2010	2009	Change	
License fee revenue:				
Direct and other distributors	$ 1,000	$ 1,360	$ (360)	(26)%
Toshiba	4,521	4,634	(113)	(2)%
Total license fee revenue	$ 5,521	$ 5,994	$ (473)	(8)%
Percent of license fee revenue:				
Direct and other distributors	18%	23%		
Toshiba	82%	77%		
Total license fee revenue	100%	100%		

The decrease in license fee revenue during the three months ended March 31, 2010, compared to the same period in 2009, was driven primarily by a decrease in the license fee revenue from outside the U.S.

Maintenance and services revenue (dollars in thousands)

	For the Three Months Ended March 31,		
	2010	2009	Change
Maintenance and services revenue:			

Maintenance and support	$	7,849	$	7,371	$	478	6%
Customer education		573		955		(382)	(40)%
Professional services		382		235		147	63%
Total maintenance and services revenue	$	8,804	$	8,561	$	243	3%

The increase in maintenance and support revenue for the three months ended March 31, 2010, compared to the same period in 2009, was due to an increase in the number of customers on maintenance contracts from new license sales. Maintenance and support revenue also included Toshiba billing adjustments relating to historic periods of $438,000 and $552,000 for the three months ended March 31, 2010 and 2009, respectively. The decrease in customer education revenue for the three months ended March 31, 2010, compared to the same period in 2009, was due to the general timing of training sessions and the effect of decreased U.S. license sales for full year 2009 compared to full year 2008. Professional services revenue increased for the three months ended March 31, 2010, compared to the same period in 2009, 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 March 31, 2010	2009	Change	
Maintenance and services revenue:				
Direct and other distributors	$ 5,144	$ 5,068	$ 76	1%
Toshiba	3,660	3,493	167	5%
Total maintenance and services revenue	$ 8,804	$ 8,561	$ 243	3%
Percent of maintenance and services revenue:				
Direct and other distributors	58%	59%		
Toshiba	42%	41%		
Total maintenance and services revenue	100%	100%		

Hardware revenue

Hardware revenue increased 86% to $434,000 during the first quarter of 2010, compared to $233,000 during the first quarter of 2009. 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, although many customers purchasing our software on an enterprise basis are choosing to also purchase the hardware for their enterprise from us. We expect hardware sales to 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 March 31, 2010	2009	Change	
Gross profit:				
License fees	$ 4,604	$ 5,024	$ (420)	(8)%
Maintenance and services	6,457	6,184	273	4%
Hardware	(6)	24	(30)	(125)%
Total gross profit	$ 11,055	$ 11,232	$ (177)	(2)%
Gross margin:				
License fees	83.4%	83.8%		
Maintenance and services	73.3%	72.2%		
Hardware	(1.4)%	10.3%		
Total gross margin	74.9%	76.0%		

License fee gross margins for the three months ended March 31, 2010 decreased slightly compared to the same period in 2009. The decrease in gross margin was primarily due to an increase in third party software sales in the first quarter of 2010 as well as the revenue mix between distribution channels.

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Maintenance and services gross margins increased for the three months ended March 31, 2010, compared to the same period in 2009, as revenue increased due to an increase in the number of customers on maintenance contracts from new license sales.

Hardware gross margins decreased for the three months ended March 31, 2010, compared to the same period in 2009, due to variability in pricing during the periods. Hardware margin was negative for the three months ended March 31, 2010, due primarily to certain bundled sales transactions for which the revenue allocated to hardware was lower than the cost of the hardware.

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 the Three Months Ended March 31, 2010	2009	Percent Change for the Three Months Ended March 31, 2009 to 2010
Operating expenses:			
Sales and marketing	37.1%	36.8%	1%
Research and development	27.3	27.1	1%
General and administrative	18.4	18.5	(1)%
Total operating expenses	82.8%	82.4%	%

Sales and marketing

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

	For the Three Months Ended March 31, 2010	2009	Change	
Salaries, benefits and bonuses	$ 2,132	$ 2,233	$ (101)	(5)%
Overhead and other expenses	804	746	58	8%
Travel, meals and entertainment	657	611	46	8%
Trade shows and advertising	607	588	19	3%
Commissions	517	496	21	4%
Equity-based compensation	430	312	118	38%
Depreciation	332	454	(122)	(27)%
Total	$ 5,479	$ 5,440	$ 39	1%

Sales and marketing expense increased slightly for the three months ended March 31, 2010, compared to the same period in 2009. Equity-based compensation increased due to the tender offer in March 2010, described in the Tender offer section below. Depreciation expense decreased as assets became fully depreciated. We had 66 and 68 sales and marketing personnel as of March 31, 2010 and 2009, respectively.

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

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Research and development

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

	For the Three Months Ended March 31,			
	2010	2009	Change	
Salaries, benefits and bonuses	$ 2,720	$ 2,955	$ (235)	(8)%
Overhead and other expenses	665	784	(119)	(15)%
Equity-based compensation	414	231	183	79%
Outside Services and consulting	309	36	273	758%
Depreciation	163	239	(76)	(32)%
Development reimbursement	(241)	(243)	2	(1)%
Total	$ 4,030	$ 4,002	$ 28	1%

The increase in research and development expenses for the three months ended March 31, 2010, compared to the same period in 2009, resulted from increased equity-based compensation due to the tender offer in March 2010, described in the Tender offer section below, which was partially offset by cost control measures. Additionally, increased outside services and consulting expenses related to test and product development services were partially offset by decreased salaries and benefits expense resulting from the termination of 20 employees in our Beijing office in August 2009 in conjunction with our decision to discontinue test and product development activities there. We had 87 and 114 research and development personnel as of March 31, 2010 and 2009, respectively.

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

General and administrative

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

	For the Three Months Ended March 31,			
	2010	2009	Change	
Salaries, benefits and bonuses	$ 1,127	$ 1,178	$ (51)	(4)%
Overhead and other expenses	555	609	(54)	(9)%
Equity-based compensation	505	369	136	37%
Accounting, auditing and legal fees	389	466	(77)	(17)%
Consulting	146	121	25	21%
Total	$ 2,722	$ 2,743	$ (21)	(1)%

The decrease in general and administrative expenses during the three months ended March 31, 2010, compared to the same period in 2009, resulted from lower headcount and other cost control measures, offset in part by an increase in equity-based compensation due to the tender offer in March 2010, described in the Tender offer section below. We had 38 and 41 general and administrative personnel as of March 31, 2010 and

2009, respectively.

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

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Tender offer

During the three months ended March 31, 2010, we initiated a cash tender offer for certain employee stock options in an effort to reduce our stock option overhang. The tender offer expired on March 19, 2010. Pursuant to the tender offer, employees tendered for purchase 360,000 options, and we accepted for purchase all such options. As a result, we paid an aggregate of $194,000 to the participating employees and incurred a equity-based compensation expense of $692,000 related to the remaining unamortized equity-based compensation expense associated with the options tendered in the offer. The tender offer applied to outstanding stock options held by employees with an exercise price equal to or greater than $25.00 per share. The price offered for each eligible stock option was less than its fair value.

The following table illustrates how equity-based compensation relating to the tender offer was allocated to