

EMAGEON INC  
Form 10-Q  
August 12, 2005

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**SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**Form 10-Q**

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

**For the quarterly period ended June 30, 2005**

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

**For the transition period from to  
Commission File No.: 0-51149  
Emageon Inc.**

*(Exact name of registrant as specified in its charter)*

**Delaware**

**63-1240138**

*(State of incorporation)*

*(I.R.S. Employer Identification No.)*

**1200 Corporate Drive, Suite 200  
Birmingham, Alabama**

**35242**

*(Address of principal executive offices)*

*(zip code)*

Registrant's telephone number, including area code:

**(205) 980-9222**

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2). YES  NO

The number of shares outstanding of the registrant's Common Stock, par value \$.001 per share, as of August 9, 2005 was 20,070,607.

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**PART I: FINANCIAL INFORMATION**  
**ITEM 1: CONSOLIDATED FINANCIAL STATEMENTS**  
**EMAGEON INC.**  
**CONSOLIDATED BALANCE SHEETS**  
**(in thousands, except for share data)**

	<b>June 30, 2005 (Unaudited)</b>	<b>December 31, 2004</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 18,394	\$ 5,994
Marketable securities	44,229	
Trade accounts receivable, net of allowance for doubtful accounts of \$100 and \$75 at June 30, 2005 and December 31, 2004, respectively	13,405	14,255
Prepaid expenses and other current assets	2,420	1,799
Deferred offering costs		1,326
Unbilled revenue	235	302
Third-party components to be sold to customers	1,925	1,422
<b>Total current assets</b>	<b>80,608</b>	<b>25,098</b>
Property and equipment, net	10,754	8,832
Restricted cash	532	903
Other noncurrent assets	116	62
Intangible assets:		
Goodwill	3,755	3,755
Acquired software, net	2,430	2,847
Capitalized software development costs, net	165	21
Trademark	250	250
<b>Total intangible assets</b>	<b>6,600</b>	<b>6,873</b>
<b>Total assets</b>	<b>\$ 98,610</b>	<b>\$ 41,768</b>
<b>LIABILITIES, REDEEMABLE PREFERRED STOCK AND STOCKHOLDERS' EQUITY (DEFICIT)</b>		
Current liabilities:		
Accounts payable	\$ 4,662	\$ 4,658
Accrued payroll and related costs	1,183	1,557
Deferred revenue	19,172	21,357
Other accrued expenses	2,093	3,838
Current portion of long-term debt	1,927	2,472
Current portion of capital lease obligations	649	620
<b>Total current liabilities</b>	<b>29,686</b>	<b>34,502</b>
Long-term deferred revenue	2,778	2,796
Deferred tax liability	95	95
Long-term debt	1,785	5,528

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Capital lease obligations, less current portion	538	869
Total liabilities	34,882	43,790
Redeemable preferred stock:		
Series B redeemable preferred stock, \$0.001 par value; 17,200,000 shares authorized, no shares and 16,885,966 shares issued and outstanding at June 30, 2005 and December 31, 2004, respectively		9,597
Series B-1 redeemable preferred stock, \$0.001 par value; 5,700,000 shares authorized, no shares and 5,652,631 shares issued and outstanding at June 30, 2005 and December 31, 2004, respectively		3,210
Series C redeemable preferred stock, \$0.001 par value; 27,500,000 shares authorized, no shares and 27,433,370 shares issued and outstanding at June 30, 2005 and December 31, 2004, respectively		11,620
Series E redeemable preferred stock, \$0.001 par value; 14,050,000 shares authorized, no shares and 14,035,087 shares issued and outstanding at June 30, 2005 and December 31, 2004, respectively		5,921
Total redeemable preferred stock		30,348
Stockholders' equity (deficit):		
Series A preferred stock, \$0.001 par value; 5,965,000 shares authorized, no shares and 5,965,000 shares issued and outstanding at June 30, 2005 and December 31, 2004, respectively		1,438
Series D preferred stock, \$0.001 par value; 18,000,000 shares authorized, no shares and 13,727,358 shares issued and no shares and 12,354,620 outstanding at June 30, 2005 and December 31, 2004, respectively		5,868
Common stock, \$0.001 par value; 66,000,000 and 165,050,000 shares authorized, 20,203,681 and 3,056,181 issued and 20,027,924 and 2,709,370 shares outstanding at June 30, 2005 and December 31, 2004, respectively	20	3
Additional paid in capital	113,312	6,998
Treasury stock, 175,757 shares, at cost	(275)	(275)
Accumulated deficit	(49,329)	(46,402)
Total stockholders' equity (deficit)	63,728	(32,370)
Total liabilities, redeemable preferred stock and stockholders' equity (deficit)	\$ 98,610	\$ 41,768

*The accompanying Notes to Consolidated Financial Statements are an integral part of these statements.*

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**EMAGEON INC.**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
**(Unaudited)**  
**(in thousands, except per share data and per share amounts)**

	For the Three Months Ended		For the Six Months Ended	
	June 30,		June 30,	
	2005	2004	2005	2004
Revenue:				
System sales	\$ 13,402	\$ 8,761	\$ 21,121	\$ 13,670
Support services	5,168	3,356	8,785	5,564
Total revenue	18,570	12,117	29,906	19,234
Cost of revenue:				
System sales	5,753	4,117	10,576	7,606
Support services	3,322	2,414	6,405	4,693
Total cost of revenue	9,075	6,531	16,981	12,299
Gross profit	9,495	5,586	12,925	6,935
Operating expenses:				
Research and development	2,533	1,303	4,918	2,573
Sales and marketing	2,521	2,407	5,210	4,145
General and administrative	2,876	1,832	5,431	3,573
Total operating expenses	7,930	5,542	15,559	10,291
Operating income (loss)	1,565	44	(2,634)	(3,356)
Other income (expense):				
Interest income	477	2	710	3
Interest expense	(142)	(190)	(994)	(383)
Total other income (expense)	335	(188)	(284)	(380)
Net income (loss)	\$ 1,900	\$ (144)	\$ (2,918)	\$ (3,736)
Net income (loss) per share basic and diluted	\$ 0.09	\$ (0.06)	\$ (0.19)	\$ (1.52)
Weighted average common stock outstanding basic	20,027,665	2,521,496	15,707,613	2,476,072
Weighted average common stock outstanding diluted	21,493,240	2,521,496	15,707,613	2,476,072

*The accompanying Notes to Consolidated Financial Statements are an integral part of these statements.*

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**EMAGEON INC.**  
**CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (DEFICIT)**  
**(Unaudited)**  
**(in thousands, except for share data)**

	Preferred Stock		Common Stock		Additional Paid in Capital	Treasury Stock	Accumulated Deficit	Total Stockholders' Equity (Deficit)
	Shares	Carrying Value	Shares	Par Value				
Balance at December 31, 2004	19,692,358	\$ 7,306	3,056,181	\$ 3	\$ 6,998	\$ (275)	\$ (46,402)	\$ (32,370)
Exercise of stock options			503		2			2
Exercise of stock warrants	105,703	58	16,504		59			117
Exercise of mandatorily redeemable stock warrants in connection with initial public offering			537,082	1	735			736
Proceeds from initial public offering, net of issuance costs			5,750,000	6	67,195			67,201
Automatic conversion of non-redeemable preferred stock into common stock in connection with initial public offering	(19,798,061)	(7,364)	2,402,898	2	7,362			
Automatic conversion of redeemable preferred stock into common stock in connection with initial public offering			8,440,513	8	30,348			30,356
Stock based compensation - options					613		(9)	613 (9)

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Accretion of redeemable preferred stock								
Net loss						(2,918)		(2,918)
Balance at June 30, 2005	\$	20,203,681	\$ 20	\$ 113,312	\$ (275)	\$ (49,329)	\$	63,728

*The accompanying Notes to Consolidated Financial Statements are an integral part of these statements.*

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**EMAGEON INC.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(Unaudited)**  
**(in thousands)**

	<b>For the Six Months Ended</b>	
	<b>June 30,</b>	
	<b>2005</b>	<b>2004</b>
<b>Operating activities</b>		
Net loss	\$ (2,918)	\$ (3,736)
Adjustments to reconcile net loss to net cash (used in) provided by operating activities:		
Depreciation	1,221	651
Depreciation of property and equipment at contracted customer sites	1,336	1,368
Amortization of acquired software	417	417
Amortization of capitalized software development costs	31	177
Bad debt expense	20	
Interest income on restricted cash	(3)	(3)
Sales discount from issuance of warrants	62	20
Consulting expense for options issued to non-employees	41	
Amortization and write off of subordinated debt discount	646	
Stock based compensation expense	572	171
Changes in operating assets and liabilities:		
Trade accounts receivable	830	(1,010)
Prepaid expenses and other current assets	(683)	(529)
Unbilled revenue	67	(1,372)
Other noncurrent assets	(54)	
Third-party components to be sold to customers	(503)	(1,105)
Accounts payable	4	159
Accrued payroll and related costs	(375)	90
Other accrued expenses	(1,745)	846
Deferred revenue	(2,203)	8,496
Net cash (used in) provided by operating activities	(3,237)	4,640
<b>Investing activities</b>		
Purchases of property and equipment for internal purposes	(3,317)	(575)
Purchases of third-party components to be located at contracted customer sites	(1,168)	(1,131)
Sales of third-party components leased to customers		1,501
Purchases of marketable securities	(59,229)	
Proceeds from maturities of marketable securities	15,000	
Capitalized software development costs	(175)	(10)
Net cash used in investing activities	(48,889)	(215)
<b>Financing activities</b>		
Proceeds from issuance of common stock, net of issuance costs	69,328	7
Proceeds from issuance of preferred stock, net of issuance costs	58	
Payments on capital lease obligations	(301)	(279)
Payments of loans	(4,933)	(868)
Proceeds from loans, net of issuance costs		3,980

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Additions to restricted cash to secure letter of credit		(96)
Cash released from restriction	374	
Net cash provided by financing activities	64,526	2,744
Net increase in cash	12,400	7,169
Cash at beginning of period	5,994	2,340
Cash at end of period	\$ 18,394	\$ 9,509

*The accompanying Notes to Consolidated Financial Statements are an integral part of these statements.*

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**EMAGEON INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(UNAUDITED)**

**(1) BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES**

The accompanying unaudited condensed consolidated financial statements of Emageon Inc. ( Emageon or 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 presentation have been included. Operating results for the three months and six months ended June 30, 2005 are not necessarily indicative of the results that may be expected for the year ending December 31, 2005. 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, 2004. Certain amounts in the prior period financial statements have been reclassified to conform to the current financial statement presentation.

*Securities Held-to-Maturity*

The Company is required to classify debt securities as held-to-maturity, available-for-sale or trading. The appropriateness of each classification is reassessed at each reporting date. As of June 30, 2005, the Company classified all debt securities as held-to-maturity . At June 30, 2005, securities held-to-maturity totaling \$44.2 million consisted of U.S. Government Agency securities and marketable corporate debt securities carried at amortized cost in accordance with the Financial Accounting Standards Board Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. The estimated fair value of all held-to-maturity securities at June 30, 2005 was approximately \$44.5 million.

*Income Taxes*

The Company accounts for income taxes using the asset and liability method. Deferred income tax assets and liabilities are determined based on differences between financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. Valuation allowances are established when necessary to reduce deferred tax assets to the amounts expected to be realized. The effective tax rate for the three months ended June 30, 2005 is zero percent due to a reduction in the valuation allowance, which equaled the tax effect of our taxable income during the quarter.

Because the majority of the deferred tax assets relate to net operating loss (NOL) carryforwards that can only be realized if the Company is profitable in future periods, it is uncertain whether the Company will realize any tax benefit related to the net operating loss carryforward. Accordingly, the Company has provided a valuation allowance against the net deferred tax assets due to uncertainties as to their ultimate realization. The valuation allowance will remain at the full amount of the deferred tax asset until it is more likely than not that the related tax benefits will be realized through deduction against taxable income during the carryforward period. In the event of certain ownership changes, the Tax Reform Act of 1986 imposes restrictions on the amount of net operating loss and research credit carryforwards that the Company may use in any year. Due to recent stock issuances, it is possible that such limitations could currently apply. The Company has not performed a detailed analysis on its ability to use these net operating loss and research credit carryforwards. However, it is not anticipated that any such analysis would have a material impact on the balance sheet as a result of offsetting changes in the deferred tax valuation allowance.

*Indemnification Provisions*

In November 2002, the Financial Accounting Standards Board ( FASB ) issued Financial Interpretation No. 45, *Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* ( FIN 45 ). FIN 45 elaborates on the disclosures to be made by a guarantor in interim and annual financial statements regarding obligations under certain guarantees. FIN 45 also clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken by

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issuing the guarantee. The accounting requirements for the initial recognition and measurement of guarantees are applicable on a prospective basis for guarantees issued or modified after December 31, 2002. The following is a summary of those of our agreements that we have determined to be within the scope of FIN 45:

(1) Our sales agreements with customers generally contain infringement indemnity provisions. Under these agreements, we agree to indemnify, defend and hold harmless the customer in connection with patent, copyright or trade secret infringement claims made by third parties with respect to the customer's authorized use of our products and services. The indemnity provisions generally provide for our control of any required defense and settlement and cover costs and damages finally awarded against the customer. Our infringement indemnity provisions typically give us the option to make modifications of the product so it is no longer infringing or, if it cannot be corrected, to require the customer to return the product in exchange for a specified payment for loss of use. Our sales agreements with customers sometimes also contain indemnity provisions for death, personal injury or property damage caused by our personnel or contractors in the course of performing services to customers. Under these agreements, we agree to indemnify, defend and hold harmless the customer in connection with death, personal injury and property damage claims made by third parties with respect to actions of our personnel or contractors. The indemnity provisions generally provide for our control of any required defense and settlement and cover costs and damages finally awarded against the customer. The indemnity obligations contained in sales agreements generally have no specified expiration date but typically limit the amount of award covered to some portion of the fees paid by the customer over some portion of the contract term. To date, we have not incurred any costs to settle claims or pay awards under these indemnification obligations, nor have we been notified of any such claims. Accordingly, we have no liabilities recorded for these provisions as of June 30, 2005.

(2) We warrant that our software products will perform in all material respects in accordance with our standard published specifications in effect at the time of delivery of the licensed products to the customer as long as the contract remains in effect. Additionally, we warrant that our services will be performed by qualified personnel in a manner consistent with normally accepted industry standards. If necessary, we would provide for the estimated cost of product and service warranties based on specific warranty claims and claim history. However, we have not incurred significant recurring expense under our product or service warranties. Accordingly, we have no liabilities recorded for these provisions as of June 30, 2005.

(3) Our standard contracts with customers typically provide for a 99% guarantee of system availability and a 98% guarantee of component availability with penalty provisions if our solution fails to meet the guarantee thresholds. Our 99% system availability guarantee covers our solution as a whole, while the component guarantee covers each individual component, as in certain circumstances a component may fail without affecting system availability. The penalty provisions in our contracts typically allow for a reduction in the software maintenance fee related to failure to meet guaranteed uptime percentages. We calculate these penalties as a percentage of the software maintenance fee and would reduce the amount of the software maintenance fee charged in a specific period for these penalties. To date, we have not incurred any penalties associated with these guarantees. Accordingly, we have no liabilities recorded for these provisions as of June 30, 2005.

**(2) COMPUTATION OF NET INCOME (LOSS) PER SHARE**

Net income (loss) per share - basic is computed using the weighted average common shares outstanding during the period. Net income (loss) per share - diluted is computed using the weighted average common shares outstanding and common share equivalents outstanding during the period. Common share equivalents consist of common convertible preferred stock, stock warrants and options to purchase common stock. Certain common share equivalents were excluded from periods with a net loss because they were anti-dilutive.

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

	For the Three Months Ended		For the Six Months Ended	
	June 30,		June 30,	
	2005	2004	2005	2004
Numerator:				
Net income (loss)	\$ 1,900	\$ (144)	\$ (2,918)	\$ (3,736)
Accretion of redemption value related to redeemable preferred stock		(17)	(9)	(33)
Net income (loss) allocable to common stockholders	\$ 1,900	\$ (161)	\$ (2,927)	\$ (3,769)
Denominator:				
Common stock outstanding at beginning of period	20,027,621	2,430,648	2,709,370	2,429,742
Weighted average effect of the release of escrowed common stock		90,242		45,121
Weighted average effect of the conversion of preferred stock to common stock			8,147,536	
Weighted average effect of the issuance of common stock in initial public offering			4,303,867	
Weighted average effect of the issuance of common stock and preferred stock pursuant to stock option and warrant exercises	44	606	418,315	1,209
Weighted average effect of the release of escrowed common stock upon completion of initial public offering			128,525	
Weighted average shares of common stock basic	20,027,665	2,521,496	15,707,613	2,476,072
Effect of dilutive stock options and warrants	1,465,575			
Weighted average shares of common stock diluted	21,493,240	2,521,496	15,707,613	2,476,072
Net income (loss) per share basic	\$ 0.09	\$ (0.06)	\$ (0.19)	\$ (1.52)
Net income (loss) per share diluted	\$ 0.09	\$ (0.06)	\$ (0.19)	\$ (1.52)

Preferred stock convertible into 10,827,403 shares of common stock for the three months and six months ended June 30, 2004 and 10,843,411 shares of common stock for the six months ended June 30, 2005, was not included in the computation of diluted earnings per share because the effect on earnings per share would have been anti-dilutive. Options and warrants to purchase 3,595,204, 2,380,202 and 3,595,204 shares of common stock for the three months ended June 30, 2004 and for the six months ended June 30, 2005 and 2004, respectively, and warrants to purchase 216,138, none and 216,138 shares of Series D preferred stock for the three months ended June 30, 2004 and the six months ended June 30, 2005 and 2004, respectively, were not included in the computation of diluted earnings per share because their effect on earnings per share would have been anti-dilutive.

(3) STOCK-BASED COMPENSATION

The Company recognizes compensation expense for its stock-based employee and director compensation plans using the intrinsic value method prescribed in Accounting Principles Board Opinion ( APB ) No. 25, *Accounting for Stock Issued to Employees* ( APB 25 ), and complies with the disclosure provisions of Statement of Financial Accounting Standard ( SFAS ) No. 123, *Accounting for Stock-Based Compensation*, as amended. Under APB 25, compensation expense of fixed stock options is based on the difference, if any, on the date of the grant between the fair value of the stock and the exercise price of the option. Compensation expense is recognized on a straight-line basis over the vesting period, which is generally three years. The Company recognizes expense for stock-based compensation issued to non-employees and non-directors at fair value in accordance with the provisions of SFAS No. 123 and Emerging Issues Task Force ( EITF ) Issue No. 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services*.

Had compensation expense for the stock-based compensation plans been determined using the fair-value method at the grant date for all employee and director awards using the Black-Scholes pricing model, the net income (loss) and related net income (loss) per share would have been as follows for the periods indicated (in thousands, except for share and per share amounts):

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	<b>For the Three Months Ended</b>		<b>For the Six Months Ended</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2005</b>	<b>2004</b>	<b>2005</b>	<b>2004</b>
Numerator:				
Actual net income (loss)	\$ 1,900	\$ (144)	\$ (2,918)	\$ (3,736)
Deduct: Accretion of redemption value related to redeemable preferred stock		(17)	(8)	(33)
Add: Total stock-based employee compensation expense determined under APB 25	290	112	572	171
Deduct: Total stock-based employee compensation expense determined under fair value method for all awards (net of tax)	(559)	(132)	(1,085)	(206)
Pro forma net income (loss) allocable to common stockholders	\$ 1,631	\$ (181)	\$ (3,439)	\$ (3,804)
Denominator:				
Weighted average shares of common stock basic	20,027,665	2,521,496	15,707,613	2,476,072
Effect of dilutive stock options and warrants	1,252,575			
Weighted average shares of common stock diluted	21,280,240	2,521,496	15,707,613	2,476,072
Pro forma net income (loss) per share basic	\$ 0.08	\$ (0.07)	\$ (0.22)	\$ (1.54)
Pro forma net income (loss) per share diluted	\$ 0.08	\$ (0.07)	\$ (0.22)	\$ (1.54)

The pro forma effects on the net income (loss) for the periods presented above are not necessarily representative of the pro forma effects that may occur in future periods.

**(4) INITIAL PUBLIC OFFERING**

On February 14, 2005, the Company completed the initial public offering of its common stock. The Company sold 5,000,000 shares of its common stock at a price of \$13.00 per share. On February 18, 2005, the over-allotment option to purchase 750,000 additional shares of common stock was exercised at \$13.00 per share. Total proceeds from the initial public offering (net of underwriting discount and offering expenses) were approximately \$67.2 million. In conjunction with the initial public offering, the Company issued 10,843,411 shares of common stock upon the automatic conversion of outstanding shares of preferred stock into shares of common stock. The Company also issued 537,082 shares of common stock upon the required exercise of warrants to purchase common stock upon the closing of the offering. The Company also released the remaining escrow holdback related to the Ultravision Medical Systems Corporation ( Ultravision ) merger upon the closing of the offering. Upon completion of the offering, 552,661 of common stock warrants with an exercise price of \$0.00825 per share were canceled. As of the close of the initial public offering, the Company had no remaining warrants to purchase preferred stock outstanding.

With a portion of the proceeds from the offering, the Company repaid \$4.0 million of its subordinated debt on February 18, 2005. Concurrent with this repayment, the Company recorded a non-cash interest charge of \$621,012 for the write-off of the debt discount related to warrants issued in connection with the subordinated debt.

**(5) MARKETABLE SECURITIES**

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At June 30, 2005, the Company had marketable debt securities that were classified as held-to-maturity and carried at amortized cost. Held-to-maturity securities consisted of the following (in thousands):

	June 30, 2005	December 31, 2004
U.S. government agency securities	\$ 34,404	\$
Corporate commercial paper	9,825	
Total held-to-maturity securities	\$ 44,229	\$

At June 30, 2005, all held-to-maturity securities were classified as current and the estimated fair value of each investment approximated its amortized cost, and, therefore, there were no significant unrealized gains or losses.

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**(6) NEW ACCOUNTING PRONOUNCEMENTS**

In December 2004, the FASB issued Statement No. 123 (revised 2004), *Share-Based Payment* ( SFAS 123R ). SFAS 123R establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services. It focuses primarily on accounting for transactions in which an entity obtains employee services in share-based payment transactions. SFAS 123R requires publicly-traded companies to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award and the estimated number of awards that are expected to vest. That cost is to be recognized over the period during which an employee is required to provide service in exchange for the award, which is usually the vesting period. SFAS 123R supersedes APB 25, which the Company had previously elected to follow. SFAS 123R will be effective for the Company at the beginning of the fiscal first quarter of 2006. SFAS 123R applies to all awards granted after the required effective date and to awards modified, repurchased, or canceled after that date. Compensation cost is recognized on or after the required effective date for the portion of outstanding awards for which the requisite services have not yet been rendered, based on the grant-date fair value of those awards calculated under SFAS 123 that the Company has followed for disclosure purposes. For periods before the required effective date, the Company may elect to adjust financial statements of prior periods on a basis consistent with the pro forma disclosures required for those periods by SFAS 123. The Company has elected not to restate prior periods. Based on stock options granted through June 30, 2005, the Company estimates that it will record additional costs relating to compensation expense as a result of the adoption of SFAS 123R starting in the first quarter of 2006.

In May 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections*, which is a replacement of APB Opinion No. 20, *Accounting Changes*, and SFAS No. 3, *Reporting Changes in Interim Financial Statements*. SFAS No. 154 applies to all voluntary changes in accounting principle and changes in the accounting for and reporting of a change in accounting principle. SFAS No. 154 requires that a change in method of depreciation or amortization for long-lived non-financial assets be accounted for as a change in accounting estimate that is effected by a change in accounting principle. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The Company does not expect that the adoption of SFAS No. 154 will have a material impact on its financial position, results of operations or cash flows.

**Table of Contents****ITEM 2: MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

The following discussion and analysis should be read in conjunction with our consolidated financial statements and related notes included in Item 1 of Part I of this quarterly report and the audited consolidated financial statements and notes and Management's Discussion and Analysis of Financial Condition and Results of Operations contained in our Annual Report on Form 10-K for the year ended December 31, 2004.

**Company Overview**

We provide an enterprise-level information technology solution for the clinical analysis and management of digital medical images within health care provider organizations. Our solution consists of advanced visualization and image management software, third-party components and comprehensive support services. Our web-enabled advanced visualization software, which is hosted by the customer, provides physicians across the enterprise in multiple medical specialties and at any network access point with tools to manipulate and analyze images in 2D and 3D. We enable physicians to better understand internal anatomic structure and pathology, improving clinical diagnoses, disease screening and therapy planning. We believe our solution improves physician productivity and patient care, enhances customer revenue opportunities, automates complex medical imaging workflow and helps to maximize our customers investment in capital equipment and clinical information systems.

**Summary**

Our revenue for the quarter ended June 30, 2005 was \$18.6 million, which represents a 53.3% increase over the corresponding quarter in 2004. This increase was comprised of a 53.0% increase in system sales revenue and a 54.0% increase in support services revenue. Our overall gross margin percentage increased from 46.1% for the quarter ended June 30, 2004 to 51.1% for the quarter ended June 30, 2005. We achieved gross margin percentages of 57.1% and 35.7% for system sales and support services revenue, respectively, during the quarter ended June 30, 2005, compared to 53.0% and 28.1%, respectively, for the corresponding quarter in 2004. We recorded net income for the quarter ended June 30, 2005 of \$1.9 million, compared with a net loss of \$0.1 million for the corresponding quarter in 2004.

As of June 30, 2005, we had \$125.9 million in contracted backlog, consisting primarily of fees for contracted future installations and for the support of existing installations, an increase over the contracted backlog of \$118.2 million at December 31, 2004. Our backlog will decrease as we recognize revenue under existing contracts, and it will increase as we enter into new contracts.

Also, during February 2005, we completed our initial public offering, selling a total of 5,750,000 shares of our common stock at a price of \$13.00 per share, which resulted in net proceeds to the Company of approximately \$67.2 million. With a portion of the proceeds from the offering, we repaid \$4.0 million of our subordinated debt. We also recorded a non-cash interest charge of \$0.6 million for the write-off of the debt discount related to warrants issued in connection with the subordinated debt.

**Critical Accounting Policies and Estimates**

Our consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States. The preparation of these consolidated financial statements requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, costs and expenses and related disclosures. On an ongoing basis, we evaluate our estimates and assumptions. Our actual results may differ from these estimates.

We believe that of our significant accounting policies, which are described in Note 2 of the notes to our consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2004, the following accounting policies involve a greater degree of judgment and complexity. Accordingly, these are the policies we believe are the most critical to aid in fully understanding and evaluating our consolidated financial condition and results of operations.

**Table of Contents***Revenue Recognition and Deferred Revenue*

We derive revenue from two primary sources: (1) system sales revenue, which includes software license revenue and third-party component sales revenue and (2) support services revenue, which includes fees related to implementation, training, software maintenance, ongoing customer support and third-party component maintenance. While the basis for software license revenue recognition is substantially governed by the provisions of AICPA Statement of Position 97-2, ( SOP 97-2 ), *Software Revenue Recognition*, as amended, in the application of this standard, we exercise judgment and use estimates in connection with the determination of the amount of software license and support services revenue to be recognized in each accounting period.

We sell software under three types of licenses:

(1) Perpetual licenses: software licensed on a perpetual basis to a customer based on a fixed number of users and/or estimates of annual study volumes where the customer has no right to return the licensed software.

(2) Enterprise licenses: software licensed on a perpetual basis to a customer (typically a multi-facility health care provider), as opposed to licensing based on a fixed number of users or on estimates of annual study volumes, where the customer has no right to return the licensed software.

(3) Term licenses: software licensed for a specific period of time according to a fixed number of users and/or estimates of annual study volumes.

Generally, our software license arrangements do not include significant modification or customization of the underlying software and, as a result, we recognize license revenue when: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred; (3) customer payment is deemed fixed or determinable and (4) collection is probable. We assess each of the four criteria as follows:

*Persuasive evidence of an arrangement exists:* Before we recognize revenue, we conduct an assessment to determine whether a binding arrangement exists with the customer counterparty. To this end, it is our customary practice to have a written contract, which is signed by both the customer and us, or a purchase order from those customers that have previously negotiated a standard end-user license arrangement, prior to recognizing revenue on an arrangement.

*Delivery has occurred:* Before we recognize revenue under any arrangement, we determine whether our software has been actually delivered to the customer counterparty. It is our customary practice to obtain formal acceptance for our software, which is evidenced by written customer acknowledgement. In the event that we grant a customer the right to specified upgrades, we defer recognition of the entire arrangement fee until we deliver the specified upgrades as we have not established vendor-specific objective evidence (VSOE) of fair value for specified upgrades. Specified upgrades include, but are not limited to, future software deliverables that are stated in the customer contract.

*The customer's payment is deemed fixed or determinable:* If we find that an arrangement exists and that delivery has occurred, before we recognize revenue in respect of any particular customer, we assess whether fees are fixed or determinable and free of contingencies or significant uncertainties at the time of sale and recognize revenue when all other applicable revenue recognition requirements are met. While our standard payment terms are net 30 days, we have, on a few occasions, extended payment terms beyond 30 days (but none greater than six months) to creditworthy customers. We have established a successful history of collection, without concessions, on these receivables; therefore satisfying the required criteria for revenue recognition. If the fee is determined not to be fixed or determinable, we recognize revenue as the amounts become due and payable.

*Collection is probable:* In addition to the three foregoing factors which we review for each customer arrangement, before we recognize any revenue for any particular customer, we also conduct an assessment of the likelihood of collection from that customer. Both new and existing customers are subjected to a credit review that evaluates such customer's financial position and ultimately its ability to pay. For follow-on sales to existing customers, prior payment history is also used to evaluate probability of collection. If it is determined from the outset of the arrangement that collection is not probable based upon our credit review



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process, revenue is recognized on a cash-collected basis if all other applicable revenue recognition criteria are met.

We account for software license and non-recurring support services revenue included in multiple element arrangements using the residual method. Under the residual method, the fair value of the undelivered elements (*i.e.*, software maintenance and ongoing support services) based on VSOE of fair value is deferred and the remaining portion of the arrangement fee is allocated to the delivered elements (*i.e.*, software license and non-recurring support services). If evidence of the fair value of one or more of the undelivered services does not exist, revenue is deferred and recognized when delivery of those services occurs or fair value can be established. We determine VSOE of fair value for ongoing support services revenue based upon the renewal rates for the maintenance and ongoing support, which coincide with our pricing model. Significant incremental discounts offered in multiple element arrangements that would be characterized as separate elements are infrequent and are allocated to software license revenue under the residual method.

For term license arrangements, we recognize revenue for the multiple element arrangement over the term of the arrangement beginning in the month after we receive customer acceptance, provided that the other applicable revenue recognition criteria have been met.

Software maintenance services generally include rights to upgrades (when and if available), telephone support, updates and bug fixes. Software maintenance revenue is recognized ratably over the term of the maintenance contract on a straight-line basis when all of the applicable revenue recognition requirements are met. We include the first year of software maintenance in the software license fee. We defer this software maintenance fee based on its fair value and recognize it ratably over the first year of the arrangement.

Ongoing support services generally include telephone support related to third-party components as well as quarterly customer metric reporting and other services. Ongoing support service revenue is recognized ratably over the term of the ongoing support services contract on a straight-line basis when all of the applicable revenue recognition requirements are met.

We recognize revenue related to the third-party components according to guidance set forth in Emerging Issues Task Force Issue No. 00-21, *Accounting for Revenue Arrangements with Multiple Deliverables* ( EITF 00-21 ). Third-party component revenue, including hardware sales and hardware maintenance, is recognized in accordance with contractual terms. When we are responsible for installing the third-party components, revenue is recognized when the third-party components are delivered, installed and accepted by the customer. When we are not responsible for installing the third-party components, revenue is recognized when the third-party components are delivered to the customer. We qualify to recognize hardware sales and hardware maintenance under EITF 00-21 as a result of the following factors: (1) our software is not essential to the functionality of the hardware, (2) our customers have the ability to purchase the hardware from other vendors and (3) the purchase price of the hardware and hardware maintenance is separately stated in our contracts.

The following is a summary of our product warranty and guarantee and our related accounting policies for these agreements:

(1) Our sales agreements with customers generally contain infringement indemnity provisions. Under these agreements, we agree to indemnify, defend and hold harmless the customer in connection with patent, copyright or trade secret infringement claims made by third parties with respect to the customer's authorized use of our products and services. The indemnity provisions generally provide for our control of any required defense and settlement and cover costs and damages finally awarded against the customer. Our infringement indemnity provisions typically give us the option to make modifications of the product so it is no longer infringing or, if it cannot be corrected, to require the customer to return the product in exchange for a specified payment for loss of use. Our sales agreements with customers sometimes also contain indemnity provisions for death, personal injury or property damage caused by our personnel or contractors in the course of performing services to customers. Under these agreements, we agree to indemnify, defend and hold harmless the customer in connection with death, personal injury and property damage claims made by third parties with respect to actions of our personnel or contractors. The indemnity provisions generally provide for our control of any required defense and settlement and cover costs and damages finally awarded against the customer. The indemnity obligations contained in sales agreements generally have no



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specified expiration date but typically limit the amount of award covered to some portion of the fees paid by the customer over some portion of the contract term. To date, we have not incurred any costs to settle claims or pay awards under these indemnification obligations, nor have we been notified of any such claims. Accordingly, we have no liabilities recorded for these provisions as of June 30, 2005.

(2) We warrant that our software products will perform in all material respects in accordance with our standard published specifications in effect at the time of delivery of the licensed products to the customer as long as the contract remains in effect. Additionally, we warrant that our services will be performed by qualified personnel in a manner consistent with normally accepted industry standards. If necessary, we would provide for the estimated cost of product and service warranties based on specific warranty claims and claim history. However, we have not incurred significant recurring expense under our product or service warranties. Accordingly, we have no liabilities recorded for these provisions as of June 30, 2005.

(3) Our standard contracts with customers typically provide for a 99% guarantee of system availability and a 98% guarantee of component availability with penalty provisions if our solution fails to meet the guarantee thresholds. Our 99% system availability guarantee covers our solution as a whole, while the component guarantee covers each individual component, as in certain circumstances a component may fail without affecting system availability. The penalty provisions in our contracts typically allow for a reduction in the software maintenance fee related to failure to meet guaranteed uptime percentages. We calculate these penalties as a percentage of the software maintenance fee and would reduce the amount of the software maintenance fee charged in a specific period for these penalties. To date, we have not incurred any penalties associated with these guarantees. Accordingly, we have no liabilities recorded for these provisions as of June 30, 2005.

Billings may not coincide with the recognition of revenue. Unbilled revenue occurs when revenue recognition precedes billing to the customer, and arises primarily from sales with predetermined billing schedules. Billings in excess of sales (deferred revenue) occur when billing to the customer precedes revenue recognition, and arise primarily from sales with partial prepayments upon contract execution and from maintenance revenue billed in advance of performance of the maintenance activity. At June 30, 2005, approximately \$1.3 million of the balance in current deferred revenue is related to two contracts where we have deferred all contract revenue accounted for under SOP 97-2 as a result of specified upgrades. The remaining balance in deferred revenue is primarily a result of timing of differences in contract execution and acceptance. The majority of our current deferred revenue relates to system sales and non-recurring services, such as implementation and training. Deferred revenue is recognized upon delivery of our products, as ongoing services are rendered or as other requirements requiring deferral under SOP 97-2 are satisfied.

The timing of customer acceptances could significantly affect the results of operations during a given period. As noted above, we generally require written acknowledgement from the customer to evidence that delivery of the products or services has occurred. Delays in the implementation process could negatively affect operations in a given period by increasing volatility in revenue recognition.

*Capitalization of Software Development Costs*

Research and development costs are charged to expense as incurred. However, the costs incurred for the development of software that will be sold, leased or otherwise marketed are capitalized when technological feasibility has been established and capitalization ceases when the software is generally available for release. Judgment is involved in determining when technological feasibility is reached. We believe that technological feasibility is reached when we have completed a working model that is ready to be beta-tested at a customer site. These capitalized costs are subject to an ongoing assessment of recoverability based on anticipated future revenue and changes in technologies. Costs that are capitalized primarily consist of direct labor.

Amortization of capitalized software development costs begins when the product is available for general release. Amortization is provided on a product-by-product basis using the straight-line method over periods not exceeding two years. Unamortized capitalized software development costs determined to be in excess of net realizable values are expensed immediately. Historically, we have had very short periods of time between when we believe a product has reached technological feasibility and the date on which we typically release our products for general release. As a result, we have not capitalized material software development costs.



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*Intangible and Other Long-Lived Assets*

In June 2001, the FASB issued SFAS No. 141, *Business Combinations* and SFAS No. 142, *Goodwill and Other Intangible Assets*. SFAS No. 141 requires the purchase method of accounting for all business combinations after June 30, 2001, and that certain acquired intangible assets in a business combination be recognized as assets separate from goodwill. We have applied SFAS No. 141 in our allocation of the purchase price of the Ultravision Medical Systems Corporation ( Ultravision ) merger, which occurred in May 2003. Accordingly, we have identified and allocated a value to the intangibles based on discounted cash flow analyses and market research, as well as our judgment. SFAS No. 142 requires that intangibles determined to have an indefinite life are not to be amortized but are to be tested for impairment at least annually. We will evaluate intangible assets for impairment on an annual basis and when impairment indicators are identified. In assessing the recoverability of intangibles, we must make assumptions regarding estimated future cash flows and other factors to determine the fair value of the respective assets. These estimates include forecasted revenue, which is inherently difficult to predict. If these estimates or their related assumptions change in the future, we may be required to record impairment charges for these assets. Historically, intangible assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Property, equipment and intangible assets are amortized over their useful lives. Useful lives of the intangible assets are based on management's estimates of the period that such assets will generate revenue.

**Change in Financial Position**

As noted above, we completed our initial public offering during February 2005. The following significant changes in our financial position occurred as a result of the completion of the initial public offering:

We issued 10,843,411 shares of common stock upon the automatic conversion of outstanding shares of preferred stock into shares of common stock.

We issued 5,750,000 shares of common stock in connection with the initial public offering.

We issued 537,082 shares of common stock upon exercise of mandatorily redeemable warrants in conjunction with the initial public offering.

We received total cash proceeds from the initial public offering (net of underwriting discount and offering expenses) of \$67.2 million.

With a portion of the proceeds from the offering, we repaid \$4.0 million of our subordinated debt.

We invested the remaining proceeds from the offering in cash equivalents and short-term marketable securities.

As of June 30, 2005, we have 20,203,681 shares of common stock issued, 20,027,924 shares of common stock outstanding and warrants to purchase 57,114 shares of common stock outstanding at exercise prices ranging from \$1.65 to \$5.52 per share. As of the close of the initial public offering, we had no remaining warrants to purchase preferred stock outstanding.

**Results of Operations**

The following tables set forth information from our unaudited Consolidated Statements of Operations for the three months and six months ended June 30, 2005 and 2004. The first two tables set forth the unaudited Consolidated Statements of Operations with accompanying calculations of the variances from period to period, in dollars and on a percentage basis for each line item. The third table presents information expressed as a percentage of total revenue except for cost of revenue related to system sales and support services, which are expressed as a percentage of system sales and support services revenue, respectively. Explanations of certain variances from period to period are contained in the paragraphs following the tables.

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	For the Three Months Ended June 30,		Variances	
	2005	2004	\$	%
	(in thousands)			
Revenue:				
System sales	\$ 13,402	\$ 8,761	\$ 4,641	53.0%
Support services	5,168	3,356	1,812	54.0
Total revenue	18,570	12,117	6,453	53.3
Cost of revenue:				
System sales	5,753	4,117	1,636	39.7
Support services	3,322	2,414	908	37.6
Total cost of revenue	9,075	6,531	2,544	39.0
Gross profit	9,495	5,586	3,909	70.0
Operating expenses:				
Research and development	2,533	1,303	1,230	94.4
Sales and marketing	2,521	2,407	114	4.7
General and administrative	2,876	1,832	1,044	57.0
Total operating expenses	7,930	5,542	2,388	43.1
Operating income	1,565	44	1,521	NM
Other income (expense):				
Interest income	477	2	475	NM
Interest expense	(142)	(190)	48	25.3
Total other income (expense).	335	(188)	523	278.2
Net income (loss)	\$ 1,900	\$ (144)	\$ 2,044	NM

	For the Six Months Ended June 30,		Variances	
	2005	2004	\$	%
	(in thousands)			
Revenue:				
System sales	\$ 21,121	\$ 13,670	\$ 7,451	54.5%
Support services	8,785	5,564	3,221	57.9
Total revenue	29,906	19,234	10,672	55.5
Cost of revenue:				
System sales	10,576	7,606	2,970	39.0
Support services	6,405	4,693	1,712	36.5

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Total cost of revenue	16,981	12,299	4,682	38.1
Gross profit	12,925	6,935	5,990	86.4
Operating expenses:				
Research and development	4,918	2,573	2,345	91.1
Sales and marketing	5,210	4,145	1,065	25.7
General and administrative	5,431	3,573	1,858	52.0
Total operating expenses	15,559	10,291	5,268	51.2
Operating loss	(2,634)	(3,356)	722	21.5
Other income (expense):				
Interest income	710	3	707	NM
Interest expense	(994)	(383)	(611)	(159.5)
Total other expense	(284)	(380)	96	25.3
Net loss	\$ (2,918)	\$ (3,736)	\$ 818	21.9%

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	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2005	2004	2005	2004
Revenue:				
System sales	72.2%	72.3%	70.6%	71.1%
Support services	27.8	27.7	29.4	28.9
Total revenue	100.0	100.0	100.0	100.0
Cost of revenue:				
System sales	42.9	47.0	50.1	55.6
Support services	64.3	71.9	72.9	84.3
Total cost of revenue	48.9	53.9	56.8	63.9
Gross profit	51.1	46.1	43.2	36.1
Operating expenses:				
Research and development	13.6	10.7	16.4	13.4
Sales and marketing	13.6	19.9	17.4	21.5
General and administrative	15.5	15.1	18.2	18.6
Total operating expenses	42.7	45.7	52.0	53.5
Operating income (loss)	8.4	0.4	(8.8)	(17.4)
Other income (expense):				
Interest income	2.6	0.0	2.4	0.0
Interest expense	(0.8)	(1.6)	(3.3)	(2.0)
Total other income (expense).	1.8	(1.6)	(0.9)	(2.0)
Net income (loss)	10.2%	(1.2)%	(9.7)%	(19.4)%

**Revenue**

Total revenue for the three months ended June 30, 2005, consisting of system sales and support services, increased by \$6.5 million, or 53.3% as compared to the corresponding period in 2004. For the six months ended June 30, 2005, revenue increased 55.5% to \$29.9 million compared with \$19.2 million for the same period in 2004. The increase in revenue for both periods in 2005 was attributable to an increase in the size and number of new customer installations as well as recognition of revenue that was deferred in the prior year due to previously undelivered elements. During the six months ended June 30, 2004 and 2005, we recognized initial system sales revenue related to seven and 22 customer contracts, respectively. All contracts for which initial system sales revenue was recognized during the six months ended June 30, 2005 were perpetual software licenses. Five out of the seven contracts for which initial system sales revenue was recognized during the six months ended June 30, 2004, were perpetual software licenses.

We believe that the increased number of our contracts was a result of increased customer awareness and acceptance of our products and services with multi-facility healthcare providers. Of the seven and 22 contracts for which we recognized initial system sales revenue during the six months ended June 30, 2004 and 2005, respectively, six and 20 of these contracts, respectively, are related to agreements with multi-facility healthcare providers. We expect revenue to continue to increase as we recognize revenue from our existing long-term customer agreements while also

recognizing revenue related to new customer agreements.

For the three and six month periods ended June 30, 2005, system sales revenue increased by \$4.6 million and \$7.5 million, respectively, which represents increases of 53.0% and 54.5%, respectively. Approximately \$1.1 million and \$2.4 million of the increases for the three and six months ended June 30, 2005, respectively, were attributable to more health care institutions buying and installing our solution, and approximately \$3.5 million and \$5.1 million of the increases for the three and six months ended June 30, 2005, respectively, were related to a general shift in our sales from term licenses, in which revenue is recognized ratably over the multiple years covered by the licenses, to perpetual licenses, in which revenue for the license fee is recognized at system acceptance assuming all applicable revenue recognition criteria have been satisfied. This shift from term licensing to perpetual licensing occurred in mid-2003 and began to have a significant impact in early 2004. We also recognized system sales revenue of \$3.4 million during the three months ended June 30, 2005 related to a contract in which we deferred

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revenue in 2004 as a result of the existence of certain undelivered upgrades. We delivered the additional software features during the current period and, as a result of all revenue recognition criteria being met, we recognized the system sales revenue associated with the contract.

For the three and six months ended June 30, 2005, support services revenue increased by \$1.8 million and \$3.2 million, respectively, which represents increases of 54.0% and 57.9%, respectively. Approximately \$1.3 million and \$2.2 million of the increases in support services revenue for the three and six months ended June 30, 2005, respectively, were attributable to an increased number of customers that have implemented our solution and are paying us ongoing support and maintenance fees. Also included in the increase for the six months ended June 30, 2005 is the recognition of \$0.4 million of revenue related to the contract mentioned in the above paragraph in which we deferred revenue in 2004 as a result of the existence of undelivered upgrades. We delivered the additional software features during the current period and, as a result of all revenue recognition criteria being met, we recognized the support services revenue catch-up adjustment during the second quarter of 2005. The remaining \$0.5 million and \$1.0 million increases in support services revenue for the three and six months ended June 30, 2005, respectively, were related to the increase in the recognition of non-recurring revenue related to services such as implementation and training for these new customers.

**Cost of Revenue**

For the three months ended June 30, 2005, cost of revenue increased by \$2.5 million, or 39.0%. For the six months ended June 30, 2005, cost of revenue increased by \$4.7 million, or 38.1%. These increases were attributable to increased purchases of third-party components as a result of the increased number and size of new customer installations. Cost of revenue as a percentage of total revenue decreased from 53.9% for the quarter ended June 30, 2004 to 48.9% for the quarter ended June 30, 2005. For the six months ended June 30, 2005, cost of revenue as a percentage of total revenue was 56.8%, a decrease from 63.9% for the corresponding period in 2004. The decrease in cost of revenue as a percentage of total revenue was a result of increased software license revenue as a percentage of total revenue as a result of our continued transition to selling perpetual software licenses. Our costs associated with software licenses as a percentage of total revenue are significantly lower than costs associated with other components of our revenue.

For the three and six months ended June 30, 2005, cost of system sales increased by \$1.6 million and \$3.0 million, respectively, which represents increases of 39.7% and 39.0%, respectively. These increases were caused by the increased number of health care institutions that acquired and installed our solution. Cost of system sales as a percentage of system sales revenue decreased from 47.0% for the quarter ended June 30, 2004 to 42.9% for the quarter ended June 30, 2005. For the six months ended June 30, 2005, cost of system sales as a percentage of total revenue was 50.1%, a decrease from 55.6% for the corresponding period in 2004. We anticipate that our cost of revenue will continue to increase in absolute dollars as a result of additional purchases of third-party components related to customer installations, which purchases are in turn driven by our increase in customers.

For the three and six months ended June 30, 2005, cost of support services increased by \$0.9 million and \$1.7 million, respectively, which represents increases of 37.6% and 36.5%, respectively. These increases were caused by an increase in staffing levels in our support services teams. Cost of support services as a percentage of support services revenue decreased from 71.9% for the quarter ended June 30, 2004 to 64.3% for the quarter ended June 30, 2005. For the six months ended June 30, 2005, cost of support services as a percentage of total revenue was 72.9%, a decrease from 84.3% for the corresponding period in 2004. The decrease in cost of support services as a percentage of total support services revenue was a result of efficiencies realized as our customer base grew and the cost of support services was spread over the broader base of customers. Additionally, in 2004, we acquired software that enabled some of our previously manual methods of providing support to be automated, thereby lowering the cost of service delivery. We continue to realize increased efficiencies as a result of utilizing this software.

**Gross Margin Percentage**

Our gross margin percentage increased from 46.1% of total revenue for the quarter ended June 30, 2004 to 51.1% of total revenue for the quarter ended June 30, 2005. For the six months ended June 30, 2005, our gross margin percentage increased to 43.2% as compared to 36.1% for the corresponding period in 2004. These



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improvements were a result of the increased revenue attributable to software licenses that have a higher margin than other components of our revenue.

**Research and Development**

For the three and six months ended June 30, 2005, research and development expenses increased by \$1.2 million and \$2.3 million, respectively, representing increases of 94.4% and 91.1%, respectively. These increases are attributable to an increase in the number of personnel, which accounted for approximately \$0.9 million and \$1.7 million of the increases, respectively, as well as increased spending for outside consultants, which accounted for approximately \$0.3 million and \$0.6 million of the increases, respectively. Research and development headcount increased to 65 employees at June 30, 2005 from 49 employees at January 1, 2004 and 60 employees at June 30, 2004. In the future, we expect to continue to invest in research and development as we continue to improve our existing technology and expand our software offering.

**Sales and Marketing**

For the three and six months ended June 30, 2005, sales and marketing expenses increased by \$0.1 million and \$1.1 million, respectively, representing increases of 4.7% and 25.7%, respectively. The relative stability in sales and marketing expenses during the three months ended June 30, 2005 as compared to the corresponding period in 2004 includes a \$0.6 million increase in personnel expenses (excluding commissions), a \$0.4 million decrease in commission expense and a decrease in direct marketing expenses of \$0.1 million. The decrease in commission expense during the three months ended June 30, 2005 as compared to the corresponding period in 2004 is primarily related to the timing of closing of contracts. The 25.7% increase from the six months ended June 30, 2005 as compared to the corresponding period in 2004 was attributable to an increase of \$1.3 million in personnel expenses, a decrease of \$0.1 million in commission expense and a decrease in direct marketing expenses of \$0.1 million. The decrease in commission expense during the six months ended June 30, 2005 as compared to the corresponding period in 2004 is primarily related to the reduced payments of commissions related to the execution of contract addenda in association with existing customer master contracts. Commission payments related to the execution of master contract addenda are generally less than the payments for new customer contracts as commissions related to the original master contracts have already been paid or are being paid and expensed on a monthly basis over the period of the master contract initial commitment. Commissions for new contract addenda that are included in the master contract are typically paid based on contract revenue above and beyond the levels in the master contract for that particular site; therefore, although the new contract addenda related to these master contracts represent major new contracts, the incremental commission expense associated with these addenda is less than the corresponding level for a similarly sized, new contract.

Sales and marketing headcount increased to 40 employees at June 30, 2005, from 29 employees at January 1, 2004 and 34 employees at June 30, 2004. For the three months ended June 30, 2005, sales and marketing expenses decreased as a percentage of total revenue, from 19.9% for the quarter ended June 30, 2004 to 13.6% for the quarter ended June 30, 2005. These percentages for the six months ended June 30, 2005 and 2004, were 17.4% and 21.5%, respectively. As we continue to increase our revenue, we believe that sales and marketing expenses as a percentage of revenue will remain relatively consistent. We expect to increase our sales and marketing expenses as we hire additional sales and marketing personnel and focus on increasing market awareness of our products and service offerings.

**General and Administrative**

For the three and six months ended June 30, 2005, general and administrative expenses increased by \$1.0 million and \$1.9 million, respectively, representing increases of 57.0% and 52.0%, respectively. The increase for the three months ended June 30, 2005, was attributable to increased expenses related to insurance and professional services, such as accounting and legal, of \$0.3 million, an increase of \$0.3 million in depreciation expense, an increase of \$0.2 million in stock-based compensation and an increase in personnel related expenses of approximately \$0.2 million. The increase for the six months ended June 30, 2005 was attributable to increased expenses related to insurance and professional services, such as accounting and legal, of \$0.6 million, an increase in personnel related expenses of approximately \$0.5 million, an increase of \$0.4 million in depreciation expense and an increase of \$0.4 million in stock-based compensation. General and administrative expenses as a percentage of total revenue increased slightly from



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15.1% for the quarter ended June 30, 2004 to 15.5% for the quarter ended June 30, 2005. General and administrative expenses as a percentage of total revenue decreased slightly from 18.6% for the six months ended June 30, 2004 to 18.2% for the six months ended June 30, 2005. Although our general and administrative expenses have increased as a result of being a public company, our general and administrative expenses as a percentage of revenue have decreased as a result of solid revenue growth. We expect our general and administrative expenses to continue to increase in absolute dollars as a result of being a public company and also as a result of our continued growth. Specifically, we expect to incur increased costs associated with accounting, consulting, legal and other professional services, increased insurance costs and increased personnel in our finance, legal and human resources functions.

**Operating Income (Loss)**

For the three months ended June 30, 2005, operating income increased by \$1.5 million as compared to the three months ended June 30, 2004. Operating income as a percentage of total revenue increased from 0.4% for the quarter ended June 30, 2004 to 8.4% for the quarter ended June 30, 2005. For the six months ended June 30, 2005, operating loss decreased by \$0.7 million as compared to the six months ended June 30, 2004. Operating loss as a percentage of total revenue decreased from 17.4% for the six months ended June 30, 2004 to 8.8% for the six months ended June 30, 2005. These improvements are a result of the total revenue increases coupled with the increased leverage in operating costs discussed above.

**Interest Income and Expense**

For the three and six months ended June 30, 2005, interest income increased by \$0.5 million and \$0.7 million, respectively, over the corresponding periods in 2004. These increases are a result of investing the proceeds from our initial public offering.

For the three months ended June 30, 2005, interest expense decreased less than \$0.1 million as compared to the corresponding period in 2004. For the six months ended June 30, 2005, interest expense increased by \$0.6 million as compared to the corresponding period in 2004 as a result of our repayment of \$4.0 million of our subordinated debt with a portion of the proceeds from our initial public offering. In conjunction with this extinguishment, we recorded a non-cash interest charge of \$0.6 million for the write-off of the subordinated debt discount related to warrants issued in connection with the subordinated debt.

**Liquidity and Capital Resources**

As of June 30, 2005, we had \$62.6 million in unrestricted cash, cash equivalents and marketable securities, working capital of \$50.9 million and \$4.9 million of borrowings, as compared to \$6.0 million of cash and cash equivalents, working capital deficit of \$9.4 million and \$9.5 million of borrowings as of December 31, 2004. As of June 30, 2005 and December 31, 2004, we had approximately \$0.5 million and \$0.9 million, respectively, of restricted cash and cash equivalents held as collateral for equipment loans related to customer third-party components and one internal equipment lease. During the quarter ended March 31, 2005, the restrictions related to one of the equipment loans were satisfied and therefore we reclassified the previously restricted amount of \$0.4 million to unrestricted cash. The remaining restrictions on cash will be released in connection with the maturity of the remaining equipment loan and the expiration of the lease, which will both occur in 2006.

***Operating Activities***

During the six months ended June 30, 2005, cash used in operations was \$3.2 million, which primarily related to our net loss of \$2.9 million and changes in working capital accounts. We also experienced a decline due to the payment of higher than usual other accrued expenses existing at December 31, 2004 during the first half of 2005. Our days sales outstanding in accounts receivable on an annualized basis as of June 30, 2005 and December 31, 2004, were 66 days and 114 days, respectively. Our weighted average collection period for accounts receivable as of June 30, 2005 was less than 50 days compared to 55 days at December 31, 2004. The changes in other working capital accounts were primarily driven by increased operations and the timing of cash payments.

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During the six months ended June 30, 2004, cash provided by operations was \$4.6 million, which consisted of an increase in cash of \$5.5 million from changes in working capital accounts and a decrease in cash of \$0.9 million as a result of our net loss offset by non-cash items. Changes in the working capital accounts primarily related to a decrease in accounts receivable, a decrease in unbilled revenue and an increase in deferred revenue due to an increased customer base and timing of customer payments. The changes in other working capital accounts were primarily driven by increased operations and the timing of cash payments.

Cash provided by and used in operating activities has historically been affected by changes in working capital accounts, primarily deferred revenue, accounts receivable and accrued expenses. Fluctuations within accounts receivable and deferred revenue are primarily related to the timing of billings and the associated revenue recognition.

*Investing Activities*

We used cash of \$48.9 million and \$0.2 million for investing activities during the first six months of 2005 and 2004, respectively.

We used \$4.5 million and \$1.7 million for property and equipment purchases during the first six months of 2005 and 2004, respectively. Approximately \$3.3 million of the purchases for the first half of 2005 related to investments in equipment for internal use, including test equipment for our research and development and quality assurance departments as well as computer equipment for new and existing personnel. Approximately \$0.6 million of the purchases for the first half of 2004 related to computer equipment for new and existing personnel. We anticipate that we will continue to purchase property and equipment as necessary in the normal course of business. Approximately \$1.2 million and \$1.1 million of the purchases for the six months ended June 30, 2005 and 2004, respectively, related to investments in equipment located at contracted customer sites. We anticipate that we will incur additional capital expenditures at customer sites as we further standardize and update our equipment platform. During the six months ended June 30, 2004, we sold equipment that we owned that had a net book value of \$1.5 million to a customer.

We used \$44.2 million for the purchase of marketable securities during the first six months of 2005. The marketable securities consist of U.S. government agency obligations and corporate commercial paper, all with maturities of less than one year.

*Financing Activities*

Cash provided by financing activities totaled \$64.5 million and \$2.7 million for the six months ended June 30, 2005 and 2004, respectively. The cash provided by financing activities for the first six months of 2005 resulted primarily from the completion of our initial public offering. This inflow of cash was offset by our \$4.0 million repayment of our subordinated debt and other payments on borrowings. During the six months ended June 30, 2005, we also had \$0.4 million of restricted cash released from restriction. The cash provided by financing activities for the first six months of 2004 resulted from proceeds from the issuance of subordinated debt of \$4.0 million, which was later repaid upon completion of our initial public offering, offset by payments on existing borrowings and an addition to restricted cash used to secure a letter of credit for an operating lease.

In April 2004, we entered into a loan and security agreement with a bank under which we can borrow up to \$4.0 million subject to certain restrictions. Interest accrues at the prime rate plus 1.5% to 2.0%, depending on our net income. This line of credit was amended as of July 31, 2004 and expires April 30, 2006 at which time all advances will be due and payable. As of June 30, 2005 we had no outstanding balance under this line of credit.

We believe our existing cash, together with future cash flows from operations and the availability under our loan and security agreement will be sufficient to execute our business plan in 2005. However, any projections of future cash inflows and outflows are subject to uncertainty. Our future capital requirements will depend on many factors, including our rate of revenue growth, the expansion of our marketing and sales activities, the timing and extent of spending to support product development efforts and expansion into new territories, the timing of introductions of new products and services and enhancements to existing products and services, and the continuing market acceptance of our solution. To the extent that our existing cash, together with future cash flows from operations and

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the availability under our loan and security agreement are insufficient to fund our future activities, we may need to raise additional funds through equity or debt financing. Although we are currently not a party to any binding agreement or letter of intent with respect to potential investments in, or acquisitions of, complementary businesses, services or technologies, we may enter into these types of arrangements in the future, which could also require us to seek additional equity or debt financing. Additional funds may not be available on terms favorable to us or at all.

**Recently Issued Accounting Pronouncements**

In December 2004, the FASB issued Statement No. 123 (revised 2004), *Share-Based Payment* (SFAS 123R). SFAS 123R establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services. It focuses primarily on accounting for transactions in which an entity obtains employee services in share-based payment transactions. SFAS 123R requires a public entity to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award and the estimated number of awards that are expected to vest. That cost will be recognized over the period during which an employee is required to provide service in exchange for the award, which is usually the vesting period. SFAS 123R supersedes APB 25, which the Company has elected to follow. SFAS 123R will be effective for the Company at the beginning of the fiscal first quarter of 2006. SFAS 123R applies to all awards granted after the required effective date and to awards modified, repurchased, or canceled after that date. Compensation cost is recognized on or after the required effective date for the portion of outstanding awards for which the requisite services have not yet been rendered, based on the grant-date fair value of those awards calculated under SFAS 123 that the Company has followed for disclosure purposes. For periods before the required effective date, the Company may elect to adjust financial statements of prior periods on a basis consistent with the pro forma disclosures required for those periods by SFAS 123. The Company has elected not to restate prior periods. Based on stock options granted through June 30, 2005, the Company estimates that it will record additional costs relating to compensation expense as a result of the adoption of SFAS 123R starting in the first quarter of 2006.

In May 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections*, which is a replacement of APB Opinion No. 20, *Accounting Changes*, and SFAS No. 3, *Reporting Changes in Interim Financial Statements*. SFAS No. 154 applies to all voluntary changes in accounting principle and changes in the accounting for and reporting of a change in accounting principle. SFAS No. 154 requires that a change in method of depreciation or amortization for long-lived non-financial assets be accounted for as a change in accounting estimate that is effected by a change in accounting principle. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The Company does not expect that the adoption of SFAS No. 154 will have a material impact on its financial position, results of operations or cash flows.

**Forward Looking Statements; Important Factors Affecting Future Results**

Some of the statements made in this section captioned *Management's Discussion and Analysis of Financial Condition and Results of Operations* contain forward-looking statements which reflect our plans, beliefs and current views with respect to, among other things, future events and financial performance. We often identify these forward-looking statements by the use of forward-looking words such as *believe*, *expect*, *potential*, *continue*, *may*, *will*, *should*, *could*, *would*, *seek*, *predict*, *intend*, *plan*, *estimate*, *anticipate* or the negative version of other comparable words. Any forward-looking statements contained in this Quarterly Report are based upon our historical performance and on current plans, estimates and expectations. The inclusion of this forward-looking information should not be regarded as a representation by us or any other person that the future plans, estimates or expectations contemplated by us will be achieved. Such forward-looking statements are subject to various risks and uncertainties. These risks, uncertainties and other factors include, among others, the risk that we may not compete successfully against larger competitors, risks associated with our history of operating losses, the risk that we may not manage our growth effectively, risks associated with our reliance on continuing relationships with large customers, the risk of significant product errors or product failures, our reliance on reseller arrangements for important components of our solution, the risk that we may not respond effectively to changes in our industry, our customers' reliance on third party reimbursements, and the potential impact on our business of FDA regulations and other applicable health care regulations. In addition, there are or will be important factors that could cause our actual results to differ materially from those indicated in these forward-looking statements.



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These cautionary statements should not be construed as exhaustive and should be read in conjunction with the other cautionary statements that are included in this Quarterly Report and in our 2004 Annual Report on Form 10-K. Moreover, we operate in a continually changing business environment, and new risks and uncertainties emerge from time to time. Management cannot predict these new risks or uncertainties, nor can it assess the impact, if any, that any such risks or uncertainties may have on our business or the extent to which any factor, or combination of factors, may cause actual results to differ from those projected in any forward-looking statement. Accordingly, the risks and uncertainties to which we are subject can be expected to change over time, and we undertake no obligation to update publicly or review the risks or uncertainties described herein. We also undertake no obligation to update publicly or review any of the forward-looking statements made in this Quarterly Report, whether as a result of new information, future developments or otherwise.

If one or more of the risks or uncertainties referred to in this Quarterly Report or in our 2004 Annual Report on Form 10-K materialize, or if our underlying assumptions prove to be incorrect, actual results may vary materially from what we projected. Any forward-looking statements you read in this prospectus reflect our current views with respect to future events and are subject to these and other risks, uncertainties and assumptions relating to our operations, financial condition, growth strategy and liquidity. You should specifically consider the factors identified in this Quarterly Report that could cause actual results to differ.

For a more complete discussion of the important factors that may impact future performance and prospects, please refer to the discussion of Risk Factors as set forth in our 2004 Annual Report on Form 10-K in the portion of Item 7 labeled Management's Discussion and Analysis of Financial Condition and Results of Operations Risk Factors.

**ITEM 3: QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Our debt instruments do not expose us to material market risks relating to changes in interest rates. Some of the proceeds of our initial public offering have been invested in short-term, interest-bearing, investment grade securities pending their application. The value of these securities will be subject to interest rate risk and could fall in value if interest rates rise. The effect of a hypothetical one hundred basis point decrease across all interest rates related to our investments would result in an annual decrease of approximately \$0.4 million in operating results assuming no further changes in the amount of our investments outstanding at June 30, 2005.

The primary objective of our investment activities is to preserve principal while maximizing the income we receive from our investments without significantly increasing our risk. We invest excess cash principally in U.S. marketable debt securities from a diversified portfolio of institutions with strong credit ratings and in U.S. government and agency bills and notes, and by policy, limit the amount of credit exposure at any one institution. These investments are generally not collateralized and mature within one year. Some of the securities we invest in may have market risk. This means that a change in prevailing interest rates may cause the fair value of the principal amount of the investment to fluctuate. To minimize this risk, we schedule our investments to have maturities that coincide with our expected cash flow needs, thus avoiding the need to redeem an investment prior to its maturity date. Accordingly, we believe we have no material exposure to interest rate risk arising from our investments. Therefore, no quantitative tabular disclosure is provided.

**ITEM 4: CONTROLS AND PROCEDURES****Evaluation of Disclosure Controls and Procedures**

Our management, with the participation of our chief executive officer and chief financial officer, evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of June 30, 2005. Based on this evaluation, our chief executive officer and chief financial officer concluded that, as of June 30, 2005, our disclosure controls and procedures were (1) designed to ensure that material information relating to us is made known to our chief executive officer and chief financial officer by others within our company, particularly during the period in which this report was being prepared and (2) effective, in that they provide reasonable assurance that information required to be disclosed by us in the reports that we file or submit

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under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms.

**Changes in Internal Control over Financial Reporting**

No change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) occurred during the fiscal quarter ended June 30, 2005 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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**PART II: OTHER INFORMATION**

**ITEM 1: LEGAL PROCEEDINGS**

None

**ITEM 2: UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

**Unregistered Sales of Equity Securities**

None

**Use of Proceeds from Initial Public Offering**

Our initial public offering of common stock was effected through a Registration Statement on Form S-1 (File No. 333-120621) that was declared effective by the Securities and Exchange Commission on February 8, 2005, pursuant to which we sold all 5,750,000 shares of our common stock registered. We received net proceeds of approximately \$67.2 million from the offering. We used \$4.0 million of the net proceeds to repay borrowings outstanding under our subordinated notes on February 18, 2005. We invested the remaining net proceeds, after payment of the subordinated notes referred to in the preceding paragraph, in short-term, investment-grade, interest bearing instruments.

During the six months ended June 30, 2005, we spent approximately \$4.5 million of such net proceeds on capital purchases, substantially all of which was spent on purchases of equipment.

**ITEM 6: EXHIBITS**

(a) Exhibit Index.

<b>Exhibit No.</b>	<b>Description</b>
10.1	Summary of Cash Incentive Compensation Criteria
31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a) or Rule 15d-14(a) under the Securities Exchange Act of 1934
31.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(a) or Rule 15d-14(a) under the Securities Exchange Act of 1934
32.1	Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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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 August 11, 2005.

**Emageon Inc.**

By: /s/ Charles A. Jett, Jr.  
Charles A. Jett, Jr.  
Chief Executive Officer  
(principal executive officer)

By: /s/ W. Randall Pittman  
W. Randall Pittman  
Chief Financial Officer and Treasurer  
(principal accounting and financial  
officer)