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MERGE TECHNOLOGIES INC
Form 10-Q
August 06, 2004

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 June 30, 2004

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

For the transition period from _____ to _____
Commission file number 0-29486

MERGE TECHNOLOGIES INCORPORATED
(Exact name of Registrant as specified in its charter.)

Wisconsin 39-1600938
(State or other jurisdiction (IRS Employer Identification No.)
of incorporation or organization)

1126 South 70th Street, Milwaukee, WI 53214-3151
(Address of principal executive offices)

(414) 977-4000
(Issuer's telephone number)

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

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

As of August 6, 2004, the issuer had 13,008,739 shares of Common Stock
outstanding.

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PART I

ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS

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

| | June 30, 2004 | December 2003 |
|--|------------------|------------------|
| | ----- | ----- |
| | (Unaudited) | |
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents..... | \$ 20,683 | \$ 16, |
| Accounts receivable, net of allowance for doubtful accounts of \$385 and \$374 at June 30, 2004 and December 31, 2003, respectively..... | 8,751 | 8, |
| Inventory..... | 958 | |
| Prepaid expenses..... | 469 | |
| Deferred tax asset..... | 2,850 | 3, |
| Other current assets..... | 491 | |
| | ----- | ----- |
| Total current assets..... | 34,202 | 30, |
| | ----- | ----- |

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| | | |
|--|-----------|--------|
| Property and equipment: | | |
| Computer equipment..... | 4,963 | 4, |
| Office equipment..... | 724 | |
| Leasehold improvements..... | 345 | |
| | ----- | ----- |
| | 6,032 | 5, |
| Less accumulated depreciation and amortization..... | 4,502 | 4, |
| | ----- | ----- |
| Net property and equipment..... | 1,530 | 1, |
| Long-term accounts receivable..... | 87 | |
| Purchased and developed software, net of accumulated amortization of \$8,344 and \$7,314 at June 30, 2004 and December 31, 2003, respectively..... | 9,170 | 8, |
| Intangibles - customer contracts, net of accumulated amortization of \$565 and \$371 at June 30, 2004 and December 31, 2003, respectively.. | 1,378 | 1, |
| Goodwill..... | 21,714 | 21, |
| Other..... | 47 | |
| | ----- | ----- |
| Total assets..... | \$ 68,128 | \$ 63, |
| | ===== | ===== |

LIABILITIES AND SHAREHOLDERS' EQUITY

| | | |
|--|----------|-------|
| Current liabilities: | | |
| Accounts payable..... | \$ 1,042 | \$ 1, |
| Accrued wages..... | 817 | |
| Notes payable..... | 221 | |
| Redemption value related to exchangeable Common Stock..... | 5 | |
| Other accrued liabilities..... | 1,003 | |
| Deferred revenue..... | 4,585 | 3, |
| Billings in excess of revenues - contracts in progress..... | 1,212 | 1, |
| | ----- | ----- |
| Total current liabilities..... | 8,885 | 8, |
| Deferred tax liability..... | 2,106 | 1, |
| | ----- | ----- |
| Total liabilities..... | 10,991 | 10, |
| | ----- | ----- |
| Shareholders' equity: | | |
| Preferred stock, \$0.01 par value: 3,999,998 shares authorized; zero shares issued and outstanding at June 30, 2004 and December 31, 2003 | \$ ---- | \$ -- |
| Series A Preferred Stock, \$0.01 par value: 1,000,000 shares authorized; zero shares issued and outstanding at June 30, 2004 and December 31, 2003..... | ---- | ---- |
| Special Voting Preferred stock, no par value: one share authorized; one share issued and outstanding at June 30, 2004 and December 31, 2003..... | ---- | ---- |
| Series 2 Special Voting Preferred stock, no par value: one share authorized; one share issued and outstanding at June 30, 2004 and December 31, 2003..... | ---- | ---- |
| Common Stock, \$0.01 par value: 30,000,000 shares authorized; 12,983,143 shares and 12,485,646 shares issued and outstanding at June 30, 2004 and December 31, 2003, respectively..... | 130 | |
| Common Stock subscribed: 1,196 and 8,058 shares at June 30, 2004 and December 31, 2003, respectively..... | 18 | |
| Additional paid-in capital..... | 53,977 | 53, |
| Retained earnings (accumulated deficit)..... | 2,795 | |
| Accumulated other comprehensive income - cumulative translation adjustment..... | 217 | |
| | ----- | ----- |
| Total shareholders' equity..... | 57,137 | 53, |
| | ----- | ----- |

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Total liabilities and shareholders' equity..... \$ 68,128 \$ 63,
=====

See accompanying notes to consolidated financial statements.

MERGE TECHNOLOGIES INCORPORATED AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)
(in thousands, except for share data)

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|--------------------------------|------------|------------------------------|----------|
| | 2004 | 2003 | 2004 | 2003 |
| Net sales..... | \$ 8,907 | \$ 6,434 | \$ 17,544 | \$ 12,5 |
| Cost of sales..... | 3,172 | 1,628 | 6,391 | 3,6 |
| Gross profit..... | 5,735 | 4,806 | 11,153 | 8,8 |
| Operating costs and expenses: | | | | |
| Sales and marketing..... | 1,711 | 1,477 | 3,405 | 2,8 |
| Product research and development..... | 423 | 397 | 905 | 8 |
| General and administrative..... | 1,024 | 865 | 1,936 | 1,5 |
| Depreciation and amortization..... | 196 | 117 | 385 | 2 |
| Total operating costs and expenses..... | 3,354 | 2,856 | 6,631 | 5,4 |
| Operating income..... | 2,381 | 1,950 | 4,522 | 3,4 |
| Other income (expense): | | | | |
| Interest expense..... | (5) | (4) | (10) | |
| Interest income..... | 49 | 12 | 103 | |
| Other, net..... | 64 | (249) | 67 | (2 |
| Total other income (expense)..... | 108 | (241) | 160 | (2 |
| Income before income taxes..... | 2,489 | 1,709 | 4,682 | 3,2 |
| Income tax expense..... | 992 | 309 | 1,831 | 4 |
| Net income..... | \$ 1,497 | \$ 1,400 | \$ 2,851 | \$ 2,7 |
| Net income per share - basic..... | \$ 0.12 | \$ 0.13 | \$ 0.22 | \$ 0. |
| Weighted average number of common shares outstanding - basic..... | 12,968,889 | 10,762,195 | 12,927,877 | 10,612,9 |
| Net income per share - diluted..... | \$ 0.11 | \$ 0.12 | \$ 0.21 | \$ 0. |
| Weighted average number of common | | | | |

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| | | | | |
|-----------------------------------|------------|------------|------------|----------|
| shares outstanding - diluted..... | 13,782,440 | 11,677,051 | 13,773,980 | 11,479,1 |
| | ===== | ===== | ===== | ===== |

See accompanying notes to consolidated financial statements.

MERGE TECHNOLOGIES INCORPORATED AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)
(in thousands)

| | Six Months Ended June 30, | |
|--|------------------------------|----------|
| | 2004 | 2003 |
| Cash flows from operating activities: | | |
| Net income..... | \$ 2,851 | \$ 2,716 |
| Adjustments to reconcile net income to net cash provided by operating activities | | |
| Depreciation and amortization..... | 1,665 | 1,107 |
| Amortization of discount on note acquired in merger..... | 8 | 7 |
| Provision for (recoveries of) doubtful accounts receivable..... | 11 | (1) |
| Deferred income taxes..... | 885 | ---- |
| Change in assets and liabilities: | | |
| Accounts receivable..... | (413) | 1,362 |
| Inventory..... | (65) | (375) |
| Prepaid expenses..... | (185) | (231) |
| Accounts payable..... | (186) | (844) |
| Accrued wages..... | (92) | 165 |
| Other accrued expenses..... | 284 | 27 |
| Deferred revenue and billings in excess of revenues..... | 720 | 553 |
| Other..... | (9) | 438 |
| Net cash provided by operating activities..... | 5,474 | 4,924 |
| Cash flows from investing activities: | | |
| Purchases of property and equipment..... | (253) | (440) |
| Capitalized software development..... | (1,873) | (1,004) |
| Net cash used in investing activities..... | (2,126) | (1,444) |
| Cash flows from financing activities: | | |
| Proceeds from notes receivable from related party..... | ---- | 25 |
| Proceeds from exercise of stock options..... | 454 | 1,046 |
| Proceeds from employee stock purchase plan..... | 37 | 61 |
| Principal payments under capital leases..... | ---- | (7) |
| Net cash provided by financing activities..... | 491 | 1,125 |
| Effect of exchange rate changes on cash..... | (27) | 134 |

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| | | |
|--|-----------|----------|
| Net increase in cash and cash equivalents..... | 3,812 | 4,739 |
| Cash and cash equivalents, beginning of period..... | 16,871 | 4,411 |
| Cash and cash equivalents, end of period..... | \$ 20,683 | \$ 9,150 |
| ----- | | |
| Supplemental Disclosures of Cash Flow Information: | | |
| Cash paid for income taxes..... | \$ 813 | \$ 146 |
| Cash paid for interest..... | ---- | 1 |
| Non-cash Financing and Investing Activities: | | |
| Redemption value related to exchangeable Common Stock..... | 1 | 33 |

See accompanying notes to consolidated financial statements.

MERGE TECHNOLOGIES INCORPORATED AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Unaudited)
(in thousands)

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|--------------------------------|----------|------------------------------|--------|
| | 2004 | 2003 | 2004 | 2003 |
| | ----- | ----- | ----- | ----- |
| Net income..... | \$ 1,497 | \$ 1,400 | \$ 2,851 | \$ 2,7 |
| Accumulated other comprehensive income - Cumulative translation adjustment..... | 33 | 155 | (15) | 2 |
| Comprehensive net income..... | \$ 1,530 | \$ 1,555 | \$ 2,836 | \$ 2,9 |
| | ===== | ===== | ===== | ===== |

See accompanying notes to consolidated financial statements.

MERGE TECHNOLOGIES INCORPORATED AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited and in thousands, except for share data)

(1) BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES

The accompanying unaudited consolidated financial statements have been prepared pursuant to the rules and regulations for reporting on Form 10-Q. Accordingly, certain information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements are not included herein. The interim statements should be read in conjunction with the consolidated financial statements and notes

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thereto included in the latest Annual Report on Form 10-K of Merge Technologies Incorporated, a Wisconsin corporation doing business as Merge eFilm, and its subsidiaries and affiliates ("we," "us" or "our").

Our accompanying unaudited consolidated financial statements reflect all adjustments of a normal recurring nature, which are, in the opinion of management, necessary to present a fair statement of our financial position and results of operations.

Stock-Based Compensation

We maintain three stock-based employee compensation plans and one director option plan. We apply the provisions of Statement of Financial Accounting Standards ("SFAS") No. 123, Accounting for Stock-Based Compensation, as amended ("SFAS No. 123"), which requires entities to recognize as expense over the vesting period the fair value of all stock-based awards on the date of grant. Alternatively, SFAS No. 123 allows entities to continue to apply the provisions of Accounting Principles Board Opinion No. 25 ("APB Opinion No. 25") and provide pro forma disclosures as if the fair value-based method defined in SFAS No. 123 had been applied.

We have elected to continue to apply the provisions of APB Opinion No. 25 in accounting for our plans. All stock options under the plans have been granted at exercise prices of not less than the market value at the date of grant, and as a result, no compensation expense has been recorded under APB Opinion No. 25. Had we determined compensation cost based on the fair value at the grant date under SFAS No. 123, our net income would have been decreased in the three and six months ended June 30, 2004 and 2003, to the pro forma amounts indicated below:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|--------------------------------|----------|------------------------------|--------|
| | 2004 | 2003 | 2004 | 2003 |
| Net income, as reported..... | \$ 1,497 | \$ 1,400 | \$ 2,851 | \$ 2,7 |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax benefits..... | (225) | (253) | (407) | (3 |
| Pro forma net income..... | \$ 1,272 | \$ 1,147 | \$ 2,444 | \$ 2,3 |
| Earnings per share: | | | | |
| Basic - as reported..... | \$ 0.12 | \$ 0.13 | \$ 0.22 | \$ 0. |
| Basic - pro forma..... | \$ 0.10 | \$ 0.10 | \$ 0.19 | \$ 0. |
| Diluted - as reported..... | \$ 0.11 | \$ 0.12 | \$ 0.21 | \$ 0. |
| Diluted - pro forma..... | \$ 0.09 | \$ 0.10 | \$ 0.18 | \$ 0. |

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Guarantees

In November 2002, the Financial Accounting Standards Board (FASB) issued Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others ("FIN 45").

MERGE TECHNOLOGIES INCORPORATED AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited and in thousands, except for share data)

FIN 45 requires that we recognize the fair value for guarantee and indemnification arrangements issued or modified by us after December 31, 2002, if these arrangements are within the scope of the interpretation. In addition, we must continue to monitor the conditions that are subject to the guarantees and indemnifications, as required under the previously existing generally accepted accounting principles, in order to identify if a loss has occurred. If we determine it is probable that a loss has occurred then any such estimable loss would be recognized under those guarantees and indemnifications. Under our standard Software License, Services and Maintenance Agreement, we agree to indemnify, defend and hold harmless our licensees from and against certain losses, damages and costs arising from claims alleging the licensees' use of our software infringes the intellectual property rights of a third party. Historically, we have not been required to pay material amounts in connection with claims asserted under these provisions and, accordingly, we have not recorded a liability relating to such provisions. Under our standard Software License, Services and Maintenance Agreement, we also represent and warrant to licensees that our software products operate substantially in accordance with published specifications, and that the services we perform will be undertaken by qualified personnel in a professional manner conforming to generally accepted industry standards and practices. Historically, only minimal costs have been incurred relating to the satisfaction of product warranty claims and, as such, no accrual for warranty claims have been made. Other guarantees include promises to indemnify, defend and hold harmless each of our executive officers, non-employee directors and certain key employees from and against losses, damages and costs incurred by each such individual in administrative, legal or investigative proceedings arising from alleged wrongdoing by the individual while acting in good faith within the scope of his or her job duties on our behalf. Historically, minimal costs have been incurred relating to such indemnifications and, as such, no accrual for these guarantees have been made.

(2) GOODWILL AND OTHER INTANGIBLES

Goodwill is our only unamortizable intangible asset. In the six months ended June 30, 2004, we reduced goodwill by \$132 due to the refund of Canadian tax credits associated with software development efforts related to periods prior to our acquisition of eFilm Medical Inc. ("eFilm"). The changes in the carrying amount of goodwill in the six months ended June 30, 2004, are as follows:

| | | |
|--|----|--------|
| Balance as of January 1, 2004..... | \$ | 21,846 |
| Goodwill related to eFilm acquisition..... | | (132) |
| | | ----- |
| Balance as of June 30, 2004..... | \$ | 21,714 |

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Our intangible assets, other than internally developed software, subject to amortization are summarized as of June 30, 2004, as follows:

| | Weighted Average Remaining Amortization Period (Years) | Gross Carrying Amount | Accumulated Amortization |
|-------------------------|--|-----------------------------|-----------------------------|
| | ----- | ----- | ----- |
| Purchased software..... | 3.4 | \$ 2,901 | \$ (941) |
| Customer contracts..... | 3.5 | 1,943 | (565) |
| | | ----- | ----- |
| Total..... | 3.4 | \$ 4,844 | \$ (1,506) |
| | | ===== | ===== |

MERGE TECHNOLOGIES INCORPORATED AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited and in thousands, except for share data)

Amortization expense was \$490 for the six months ended June 30, 2004. Estimated aggregate amortization expense for each of the next five years is as follows:

| | | |
|-------------------------------|------|--------|
| For the remaining six months: | 2004 | \$ 484 |
| For the year ended: | 2005 | \$ 935 |
| | 2006 | \$ 924 |
| | 2007 | \$ 708 |
| | 2008 | \$ 287 |

(3) INCOME PER SHARE

Basic earnings per share are computed by dividing income available to common shareholders by the weighted average number of common shares and share exchange rights outstanding if conversion is dilutive to the calculation. Diluted earnings per share reflects the potential dilution that could occur based on the exercise of stock options and warrants with an exercise price of less than the average market price of our Common Stock. The following table sets forth the computation of basic and diluted earnings per share for the three and six months ended June 30, 2004 and 2003.

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---------------------------------------|--------------------------------|----------|------------------------------|--------|
| | ----- | ----- | ----- | ----- |
| | 2004 | 2003 | 2004 | 2003 |
| | ----- | ----- | ----- | ----- |
| Numerator: | | | | |
| Net Income..... | \$ 1,497 | \$ 1,400 | \$ 2,851 | \$ 2,7 |
| Accretion of redemption value related | | | | |

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| | | | | |
|---|------------|------------|------------|----------|
| to Interpra exchangeable shares..... | ---- | (12) | (1) | (|
| Allocation of income to Interpra exchangeable shares..... | ---- | (17) | (1) | (|
| | ----- | ----- | ----- | ----- |
| Numerator for net income per shares | | | | |
| - basic and diluted..... | \$ 1,497 | \$ 1,371 | \$ 2,849 | \$ 2,6 |
| | ===== | ===== | ===== | ===== |
| Denominator: | | | | |
| Weighted average number of shares of Common Stock and participating securities outstanding..... | 12,968,889 | 10,762,195 | 12,927,877 | 10,612,9 |
| | ----- | ----- | ----- | ----- |
| Effect of stock option..... | 813,551 | 857,477 | 846,103 | 788,2 |
| Effect of warrants..... | ---- | 57,379 | ---- | 77,9 |
| | ----- | ----- | ----- | ----- |
| Denominator for net income per share - diluted..... | 13,782,440 | 11,677,051 | 13,773,980 | 11,479,1 |
| | ===== | ===== | ===== | ===== |
| Net income per share - basic..... | \$ 0.12 | \$ 0.13 | \$ 0.22 | \$ 0. |
| Net income per share - diluted..... | \$ 0.11 | \$ 0.12 | \$ 0.21 | \$ 0. |

For the three months ended June 30, 2004 and 2003, 43,000 and 35,000, respectively, of options and warrants to purchase shares of our Common Stock had exercise prices greater than the average market price of the shares of Common Stock.

For the six months ended June 30, 2004 and 2003, 130,000 and 35,000, respectively, of options and warrants to purchase shares of our Common Stock had exercise prices greater than the average market price of the shares of Common Stock.

(4) ACQUISITIONS

On July 17, 2003, we acquired all of the outstanding capital stock of RIS Logic, Inc. ("RIS Logic") pursuant to a Merger Agreement dated July 9, 2003, for a total purchase price of \$16,984 consisting primarily of cash, vested options and 771,804 shares of Common Stock. RIS Logic has been in the business of the development and sales of Radiology Information System ("RIS") products to end user imaging centers.

We paid a significant premium above the fair value of RIS Logic's tangible net assets principally because we determined that RIS Logic's software development ability and trade name are particularly important to us. As we

MERGE TECHNOLOGIES INCORPORATED AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited and in thousands, except for share data)

looked to the future, we foresaw the need to expand our software product offerings to healthcare institutions and imaging centers as many of our competitors are developing more integrated solutions. In addition, we expect to be able to sell our software products to RIS Logic's customers. The fair value of each share issued to RIS Logic was determined to be \$14.305 using a four-day average of the closing price of our Common Stock before and after the signing of the definitive agreement.

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An escrow of 173,093 shares of Common Stock was established as a reserve for 18 months, which will terminate on January 16, 2005, against any claims regarding breaches or representations and warranties.

The acquisition was accounted for using the purchase method of accounting. The accompanying consolidated statements of operations include the results of operations for RIS Logic since the acquisition date, July 17, 2003. The amount allocated to purchased and developed software is being amortized over a five-year period. The estimated asset life is determined based on projected future economic benefits and expected life cycles of the technologies. The amount assigned to goodwill is not being amortized, but will be tested for impairment annually or under certain circumstances that may indicate a potential impairment. The following is a summary of purchase consideration for the acquisition of RIS Logic:

| Form of Consideration | Fair Value |
|-------------------------------------|------------|
| ----- | ----- |
| Cash..... | \$ 4,311 |
| 771,804 shares of Common Stock..... | 11,041 |
| Vested stock options..... | 1,452 |
| Transaction costs..... | 180 |
| | ----- |
| Total consideration..... | \$ 16,984 |
| | ===== |

The total purchase consideration of approximately \$16,984 was allocated to the fair value of the net assets acquired as follows:

| | Fair Value |
|--------------------------------------|------------|
| | ----- |
| Current assets..... | \$ 2,184 |
| Other assets..... | 247 |
| Purchased and developed technologies | 1,483 |
| Customer contracts..... | 977 |
| Goodwill..... | 14,469 |
| Liabilities assumed..... | (2,376) |
| | ----- |
| Total consideration..... | \$ 16,984 |
| | ===== |

Of the amount assigned to goodwill in the acquisition, the \$14,469 will not be deductible for federal income tax purposes.

The following unaudited pro forma information shows the results of our operations for the six months ended June 30, 2003, as if the RIS Logic business combination had occurred at the beginning of the period. This data is not indicative of the results of operations that would have arisen if the business combination had occurred at the beginning of 2003. Moreover, this data is not intended to be indicative of future results of operations.

| | |
|---------------------|-----------|
| Revenue..... | \$ 14,520 |
| Net income..... | \$ 1,751 |
| Earnings per share: | |
| Basic..... | \$ 0.15 |
| Diluted..... | \$ 0.14 |

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION

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AND RESULTS OF OPERATIONS

Special Note on Forward-Looking Statements

Certain statements in this report that are not historical facts constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933, as amended (the "Securities Act"), and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Discussions containing such forward-looking statements may be included herein in the material set forth under Management's Discussion and Analysis of Financial Condition and Results of Operations, as well as within this report generally. In addition, when used in this report, the words: believes, intends, anticipates, expects and similar expressions are intended to identify forward-looking statements. These statements are subject to a number of risks and uncertainties, including, among others and in addition to those listed under Factors That May Affect Future Results of Operations, Financial Condition or Business, our lack of consistent profitability, fluctuations in operating results, credit and payment risks associated with end-user sales, involvement with rapidly developing technology in highly competitive markets, acquisition and development of new technologies, dependence on major customers, expansion of our international sales effort, broad discretion of management and dependence on key personnel, risks associated with product liability and product defects, risks of loss associated with potential infringement of our products or services on the intellectual property rights of others, costs of complying with government regulation, changes in external competitive market factors which might impact trends in our results of operation, unanticipated working capital and other cash requirements, general changes in the industries in which we compete, and various other competitive factors that may prevent us from competing successfully in the marketplace. Actual results could differ materially from those projected in the forward-looking statements. We undertake no obligation to publicly release the result of any revisions to these forward-looking statements that may be made to reflect any future events or circumstances. Our actual results and the timing of certain events may differ materially from those reflected in the forward-looking statements. The following discussion should be read in conjunction with the condensed consolidated financial statements and notes thereto appearing elsewhere in this report.

Overview

We started operations in 1987 and are a leading provider of Picture Archiving and Communications Systems ("PACS") and RIS software to imaging centers, specialty clinics, small and medium sized hospitals, and PACS component and connectivity technologies to many Original Equipment Manufacturers ("OEM's") throughout the world. We have been an active leader in the development in the industry standard network communications protocol known as Digital Imaging Communications in Medicine ("DICOM") technology which defines the standard configuration for digital imaging. DICOM is used by virtually all OEM's building modalities for healthcare.

Our products fuse business and clinical workflow by intelligently managing and distributing diagnostic images and information throughout the healthcare enterprise. By utilizing our products, our customers enhance the quality of healthcare provided to patients because they improve radiology workflow efficiencies and improve the clinical decision making processes. In addition, our products reduce the film, paper and labor costs involved in managing and distributing medical images and information, thereby contributing to the profitability of our customers' businesses. We deliver this tangible

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value to facilities of all sizes, but we specifically target imaging centers, small to medium size hospitals, multi-hospital groups, and specialty clinics.

Healthcare providers continue to be challenged by declining reimbursements, competition and reduced operating profits brought about by the double-digit increases in healthcare expenditures. Within the United States of America, we are focusing our direct sales efforts on single and multi-site imaging centers with more than 10,000 studies per year, small to medium sized hospitals (less than 400 beds), and certain specialty clinics like orthopedic practices that offer imaging services. The Frost and Sullivan 2002 survey indicated that less than 30% of those markets are currently using a PACS to achieve a filmless workflow environment and an even smaller percentage has a fully integrated RIS/PACS delivering filmless and paperless workflow.

The markets for our products are highly competitive. Many customers purchase products from us and from our competitors as well. Our historical connectivity solutions product line has been the mainstay, which pioneered our

development. The competitive challenge is that similar products are readily available and the connectivity products are incorporated into most imaging modalities. In the developing area of RIS and PACS workflow software applications, there are many newly emerging competitors who offer portions of the integrated radiology solution through their RIS and PACS to the market targeted by us. Additionally, certain competitors are integrating RIS and PACS technologies through development, partnership and acquisition activities. We rely on our global brand and historical installation base as the market leader in connectivity products and desktop software image viewing applications, eFilm Workstation(tm). This installed base, reputation for clinical and technical quality and long-term service is a key differentiator among the competition. In addition, our software modular technique to implementing a customized, fully integrated solution is appealing to our target market and is the foundation of our approach.

We have aggressively expanded our product offering, especially in the past two years, through our acquisitions of eFilm and RIS Logic. We became a full PACS provider in June 2002 through our acquisition of eFilm which provided the visualization platform, which when combined with our existing PACS components, allowed us to release our first integrated PACS system for the small and medium sized hospital and imaging center market. The eFilm Workstation(tm) also is core to our strategy to "own" the clinician desktop market. We sell our eFilm Workstation(tm) on the Internet for a small annual subscription. This strategy allows radiologists or clinicians reluctant to move to reading images digitally, to do so easily and very inexpensively, particularly relative to other similar clinical diagnostic tools on the market.

Our July 2003 acquisition of RIS Logic allowed us to become one of the first providers of integrated RIS/PACS solutions in our target market. We saw this as a growing need of our target market. The integrated RIS/PACS solution positions us to fundamentally own the technology necessary to run an imaging center by having PACS deliver filmless workflow and a RIS deliver paperless workflow. We see these products as core elements behind our success in achieving our results in the three and six months ended June 30, 2004, and for the foreseeable future.

SIGNIFICANT EVENTS IN THE THREE MONTHS ENDED JUNE 30, 2004

During the three months ended June 30, 2004, we placed continued

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emphasis on North American direct sales, the design and development of our next generation RIS/PACS in close collaboration with our customers, and the strengthening of our professional services organization. We continue to see accelerating interest from our target market for a comprehensive workflow solution from a single, trusted healthcare software solutions provider. In response to this trend, we are driving our North American distribution strategy through a combination of direct sales and new business development relationships that broaden our market coverage. We have remained consistent in our focus on imaging centers, small to medium size hospitals, and specialty clinics, including a growing target market of orthopedic groups and neurosurgery centers that recognize the value of integrating PACS solutions into their clinical practice.

Our OEM/value added resellers ("VARs") channel continued to experience challenges achieving their financial goals; however, we are encouraged by progress with key OEM customers and our European VARs. A new software product line customized for a leading OEM in Europe was released and began generating sales in the three months ended June 30, 2004. Several European VARs purchased FUSION(tm) PACS software modules and components for their customers in the three months ended June 30, 2004. Additionally, we believe that the recent new leadership of our OEM and international team will produce improved results in the second half of 2004.

During the three months ended June 30, 2004, we successfully closed 20 new FUSION(tm) RIS, PACS or RIS/PACS contracts, growing our total number of FUSION(tm) solution customers to 160, representing over 320 healthcare facilities.

During the three months ended June 30, 2004, we released several new FUSION(tm) software products, including our next generation RIS/PACS with single desktop integration, enhanced versions of FUSION(tm) PACS with web capabilities and new modules of functionality such as FUSION(tm) PACS voice recognition and FUSION(tm) RIS document management.

In July 2004, we signed a distribution agreement with SourceOne Healthcare Technologies ("SourceOne") to sell our FUSION(tm) PACS, RIS and RIS/PACS software products as part of our strategy to rapidly expand our ability to cover the North American healthcare market. SourceOne brings over 120 sales professionals to the relationship. With the combined strengths of both organizations, this partnership provides our target market and SourceOne's customers with the radiology workflow expertise to deliver a solution aligned with the customers' current needs, along with a future growth towards seamless digital, paperless and filmless, workflow.

RESULTS OF OPERATIONS (in thousands)

Three Months Ended June 30, 2004 Compared to Three Months Ended June 30, 2003

The following table sets forth selected unaudited consolidated financial data for the periods indicated, expressed as a percentage of net sales.

| Three Months Ended June 30, | |
|--------------------------------|-------|
| ----- | ----- |
| 2004 | 2003 |
| ---- | ---- |

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| | | |
|---|-------|-------|
| Net sales..... | 100% | 100% |
| Cost of sales..... | 36 | 25 |
| | ---- | ---- |
| Gross profit..... | 64 | 75 |
| | ---- | ---- |
| Operating costs and expenses: | | |
| Sales and marketing..... | 19 | 24 |
| Product research and development..... | 5 | 6 |
| General and administrative..... | 11 | 13 |
| Depreciation and amortization..... | 2 | 2 |
| | ---- | ---- |
| Total operating costs and expenses..... | 37 | 45 |
| | ---- | ---- |
| Operating income..... | 27 | 30 |
| Total other income (expense), net..... | 1 | (4) |
| | ---- | ---- |
| Income before income taxes..... | 28 | 26 |
| | | |
| Income tax expense..... | 11 | 4 |
| | ---- | ---- |
| Net income..... | 17% | 22% |
| | ===== | ===== |

Net Sales

Net sales consist of sales made directly to healthcare facilities, the professional services associated with those sales and sales made to OEM/VARs, net of estimated product returns. Net sales for the three months ended June 30, 2004 include the results of our acquisition of RIS Logic on July 17, 2003. The following table sets forth net sales component data.

| | Three Months Ended June 30, | | % Change |
|---|--------------------------------|----------|----------|
| | 2004 | 2003 | |
| | ----- | ----- | ----- |
| Direct sales..... | \$ 3,738 | \$ 1,869 | 100% |
| As a percentage of total net sales..... | 42% | 29% | |
| Professional services..... | \$ 2,794 | \$ 1,389 | 101% |
| As a percentage of total net sales..... | 31% | 22% | |
| OEM/VARs..... | \$ 2,375 | \$ 3,176 | (25%) |
| As a percentage of total net sales..... | 27% | 49% | |
| Total net sales..... | \$ 8,907 | \$ 6,434 | 38% |

Direct sales consist of software and purchased components delivered in PACS, RIS and RIS/PACS sales to healthcare facilities and imaging centers. The \$1,869 increase in direct sales in the three months ended June 30, 2004 compared to June 30, 2003 is attributed to increased revenue recognized on RIS, PACS or

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RIS/PACS deals, including 20 new sales closed during the three months ended June 30, 2004.

Net sales from the professional services group increased \$1,405 in the three months ended June 30, 2004 compared to the three months ended June 30, 2003. The net sales growth from the professional services group is due to the growth in sales made directly to healthcare facilities and imaging centers, where such sales are accompanied by installation services and service contracts.

Net sales to OEM/VARs and dealers decreased \$801 in the three months ended June 30, 2004 attributed to the continued shift in our focus from regional VARs to targeting a national business development relationship in the United States of America and an overall decrease in international OEM/VAR sales.

Cost of Sales

Cost of sales consists of purchased components and service costs associated with net sales, amortization of purchased and developed software and acquired customer contracts.

The cost of purchased components increased to \$962 in the three months ended June 30, 2004 compared to \$533 in the three months ended June 30, 2003, as a result of the purchased components included in RIS, PACS, and RIS/PACS sales during the three months ended June 30, 2004. The three months ended June 30, 2003 include the recovery of a provision of \$270 associated with inventory returned from a 2002 sale and an unusually high number of PACS sales with no associated hardware components (i.e. software only sales).

The cost of professional services increased to \$1,568 in the three months ended June 30, 2004 compared to \$648 in the three months ended June 30, 2003. The increase is due to the growing number of RIS, PACS and RIS/PACS sales in 2004 and required headcount growth to install and maintain ongoing service and support for direct sales customers. The costs for the three months ended June 30, 2003 do not reflect headcount from our acquisition of RIS Logic in the third quarter of 2003.

Amortization of purchased and developed software increased to \$642 in the three months ended June 30, 2004 compared to \$447 in the three months ended June 30, 2003. As a percentage of net sales, amortization of purchased and developed software remained constant at 7% in the three months ended June 30, 2004 and June 30, 2003. The dollar increase in the three months ended June 30, 2004 is a result of the commencement of amortization on software available for general release and the amortization of the intellectual property and customer contracts acquired in the acquisition of RIS Logic.

Gross Profit

Gross profit increased 19% to \$5,735 in the three months ended June 30, 2004 from \$4,806 in the three months ended June 30, 2003. As a percentage of net sales, gross profit decreased to 64% of net sales in the three months ended June 30, 2004 compared to 75% in the three months ended June 30, 2003. The gross profit for the three months ended June 30, 2003 is unusually high as the result of the previously mentioned \$270 provision recovery in addition to the fact that direct sales in the three months ended June 30, 2003 consisted of an unusually high percentage of software only PACS sales.

Sales and Marketing

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Sales and marketing expense increased 16% to \$1,711 in the three months ended June 30, 2004 from \$1,477 in the three months ended June 30, 2003. The increase is the result of our objective to invest in sales and marketing activities, particularly for sales team efforts in connection with sales made directly to healthcare facilities and imaging centers. In addition, sales

staff headcount increased in the three months ended June 30, 2004, compared to the three months ended June 30, 2003, as a result of normal hiring and sales people assumed in connection with the acquisition of RIS Logic.

Product Research and Development

Research and development expense as a percentage of net sales remained relatively consistent at 5% for the three months ended June 30, 2004 compared to 6% for the three months ended June 30, 2003. Research and development expense increased 7% to \$423 in the three months ended June 30, 2004 from \$397 in the three months ended June 30, 2003. Capitalization of software development costs increased \$379 to \$915 in the three months ended June 30, 2004, from \$536 in the three months ended June 30, 2003, as a result of our developing FUSION(tm) application modules and further integration of our RIS/PACS technologies.

General and Administrative

General and administrative expense as a percentage of net sales decreased slightly to 11% for the three months ended June 30, 2004 compared to 13% for the three months ended June 30, 2003. General and administrative expense increased 18% to \$1,024 in the three months ended June 30, 2004 from \$865 in the three months ended June 30, 2003. General and administrative expense includes costs for information systems, accounting, administrative support, management personnel, bad debt expenses and general corporate matters. The \$159 increase is primarily attributed to increased costs associated with corporate governance and compliance with the Sarbanes - Oxley Act of 2002, as well as recruiting fees associated with the continued hiring of sales and service personnel.

Depreciation and Amortization

Depreciation and amortization expense as a percentage of net sales remained constant at 2% for the three months ended June 30, 2004 and June 30, 2003. Depreciation and amortization expense increased 68% to \$196 in the three months ended June 30, 2004 from \$117 in the three months ended June 30, 2003. Depreciation and amortization is assessed on capital equipment and intangible assets with estimable useful lives. This is net of the amortization of capitalized software, which is a component of cost of sales.

Other Income, Expense

Our interest expense remained consistent at \$5 in the three months ended June 30, 2004 from \$4 in the three months ended June 30, 2003, and interest income was \$49 in the three months ended June 30, 2004 compared to \$12 in the three months ended June 30, 2003. The increase in interest income is directly attributed to our increased cash and cash equivalents balance at June 30, 2004. Other income, net, was \$64 in the three months ended June 30, 2004 compared to other expense, net of \$249 in the three months ended June 30, 2003. The other

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income, net for the three months ended June 30, 2004 is primarily attributed to the recovery from an insurance claim filed in 2003 for business interruption. The other expense, net for the three months ended June 30, 2003 is primarily attributed to unrealized foreign exchange losses on United States dollar receivables and cash held in our Canadian subsidiary, where the functional currency is the Canadian dollar.

Income Taxes

We recorded income tax expense of \$992 in the three months ended June 30, 2004 and \$309 in the three months ended June 30, 2003. The increase is attributable to an adjustment of our estimated domestic and international effective rate for the full fiscal year of 39%, compared to the adjustment for the estimated full 2003 fiscal year rate of 15%. The 2003 effective tax was benefited by the reduction of valuation allowances associated with net operating loss and tax credit carryforwards.

Six Months Ended June 30, 2004 Compared to Six Months Ended June 30, 2003

The following table sets forth selected unaudited consolidated financial data for the periods indicated, expressed as a percentage of net sales.

| | Six Months Ended June 30, | |
|---|------------------------------|------|
| | 2004 | 2003 |
| Net sales..... | 100% | 100% |
| Cost of sales..... | 36 | 29 |
| Gross profit..... | 64 | 71 |
| Operating costs and expenses: | | |
| Sales and marketing..... | 20 | 22 |
| Product research and development..... | 5 | 7 |
| General and administrative..... | 11 | 13 |
| Depreciation and amortization..... | 2 | 2 |
| Total operating costs and expenses..... | 38 | 44 |
| Operating income..... | 26 | 27 |
| Total other income (expense), net..... | 1 | (2) |
| Income before income taxes..... | 27 | 25 |
| Income tax expense..... | 11 | 4 |
| Net income..... | 16% | 21% |

Net Sales

Net sales consist of sales made directly to healthcare facilities, the professional services associated with those sales and sales made to OEM/VARs, net of estimated product returns. Net sales for the six months ended June 30,

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2004 include the results of our acquisition of RIS Logic on July 17, 2003. The following table sets forth net sales component data.

| | Six Months Ended June 30, | | % Change ----- |
|---|------------------------------|-----------|-------------------|
| | 2004 | 2003 | |
| Direct sales..... | \$ 7,411 | \$ 3,207 | 131% |
| As a percentage of total net sales..... | 42% | 26% | |
| Professional services..... | \$ 5,275 | \$ 2,746 | 92% |
| As a percentage of total net sales..... | 30% | 22% | |
| OEM/VARs..... | \$ 4,858 | \$ 6,599 | (26%) |
| As a percentage of total net sales..... | 28% | 53% | |
| Total net sales..... | \$ 17,544 | \$ 12,552 | 40% |

Direct sales consist of software and purchased components delivered in PACS, RIS and RIS/PACS sales to healthcare facilities and imaging centers. The \$4,204 increase in direct sales in the six months ended June 30, 2004 compared to June 30, 2003 is attributed to increased revenue recognized on RIS, PACS or RIS/PACS deals, including 37 new sales closed during the six months ended June 30, 2004.

Net sales from the professional services group increased \$2,529 in the six months ended June 30, 2004 compared to the six months ended June 30, 2003. The net sales growth from the professional services group is due to the growth in sales made directly to healthcare facilities and imaging centers, where such sales are accompanied by installation services and service contracts. We

anticipate net sales from the professional services group to continue to grow as part of the overall growth in sales made directly to healthcare facilities and imaging centers.

Net sales to OEM/VARs and dealers decreased \$1,741 in the six months ended June 30, 2004 attributed to the continued shift in our focus from regional VARs to targeting national business development relationships in the United States of America and unusually low sales from European VARs in 2004 in addition to a long-term OEM component business with one customer reaching the end of its contractual life during 2004. We anticipate growth in the OEM/VAR group for the remainder of 2004 compared to the first six months.

Cost of Sales -----

Cost of sales consists of purchased components and service costs associated with net sales, amortization of purchased and developed software and acquired customer contracts.

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The cost of purchased components increased to \$2,077 in the six months ended June 30, 2004 compared to \$1,518 in the six months ended June 30, 2003, as a result of the purchased components included in RIS/PACS deals recognized under the percentage-of-completion method of contract accounting and PACS only sales during the six months ended June 30, 2004.

The cost of professional services increased to \$3,034 in the six months ended June 30, 2004 compared to \$1,253 in the six months ended June 30, 2003. The increase is due to the growing number of RIS, PACS and RIS/PACS sales in 2004 and required headcount growth to install and maintain ongoing service and support for direct sales customers. In addition, we re-assigned several pre-sales and technical staff to the professional services group in first three months of 2004 to keep pace with the increased installation demand. The costs for the six months ended June 30, 2003 do not reflect headcount from our acquisition of RIS Logic in the third quarter of 2003.

Amortization of purchased and developed software increased to \$1,280 in the six months ended June 30, 2004 compared to \$909 in the six months ended June 30, 2003. As a percentage of net sales, amortization of purchased and developed software remained constant at 7% in the six months ended June 30, 2004 and June 30, 2003. The dollar increase in the six months ended June 30, 2004 is a result of the commencement of amortization on software available for general release and the amortization of the intellectual property and customer contracts acquired in the acquisition of RIS Logic.

Gross Profit

Gross profit increased 26% to \$11,153 in the six months ended June 30, 2004 from \$8,872 in the six months ended June 30, 2003. As a percentage of net sales, gross profit decreased to 64% of net sales in the six months ended June 30, 2004 compared to 71% in the six months ended June 30, 2003. The decrease in gross profit as a percentage of sales is due to the increased professional service costs previously discussed and the fact that direct sales in the six months ended June 30, 2003 consisted of an unusually high percentage of software only PACS sales which resulted in a high gross margin.

Sales and Marketing

Sales and marketing expense increased 22% to \$3,405 in the six months ended June 30, 2004 from \$2,802 in the six months ended June 30, 2003. The increase is the result of our objective to invest in sales and marketing activities, particularly for sales team efforts in connection with sales made directly to healthcare facilities and imaging centers. In addition, sales staff headcount increased in the six months ended June 30, 2004, compared to the six months ended June 30, 2003, as a result of normal hiring and sales people assumed in connection with the acquisition of RIS Logic.

Product Research and Development

Research and development expense as a percentage of net sales remained relatively consistent at 5% for the six months ended June 30, 2004 compared to 7% for the six months ended June 30, 2003. Research and development expense increased 8% to \$905 in the six months ended June 30, 2004 from \$836 in the six months ended June 30, 2003. Capitalization of software development costs

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increased \$869 to \$1,873 in the six months ended June 30, 2004, from \$1,004 in the six months ended June 30, 2003, as a result of our developing FUSION(tm) application modules and further integration of our RIS/PACS technologies during 2004.

General and Administrative

General and administrative expense as a percentage of net sales decreased slightly to 11% for the six months ended June 30, 2004 compared to 13% for the six months ended June 30, 2003. General and administrative expense increased 22% to \$1,936 in the six months ended June 30, 2004 from \$1,587 in the six months ended June 30, 2003. General and administrative expense includes costs for information systems, accounting, administrative support, management personnel, bad debt expenses and general corporate matters. The \$349 increase is primarily attributed to increased costs associated with corporate governance and compliance with the Sarbanes - Oxley Act of 2002, as well as recruiting fees associated with the continued hiring of sales and service personnel.

Depreciation and Amortization

Depreciation and amortization expense as a percentage of net sales remained constant at 2% for the six months ended June 30, 2004 and June 30, 2003. Depreciation and amortization expense increased \$162 to \$385 in the three months ended June 30, 2004 from \$223 in the three months ended June 30, 2003. Depreciation and amortization is assessed on capital equipment and intangible assets with estimable useful lives. This is net of the amortization of capitalized software, which is a component of cost of sales. Depreciation and amortization expense is expected to increase in 2004 over 2003 as we increase our capital expenditures to support our growth.

Other Income, Expense

Our interest expense remained consistent at \$10 in the six months ended June 30, 2004 from \$8 in the six months ended June 30, 2003, and interest income was \$103 in the six months ended June 30, 2004 compared to \$25 in the six months ended June 30, 2003. The increase in interest income is directly attributed to our increased cash and cash equivalent balance throughout the first six months of 2004 compared to the first six months of 2003. Other income, net, was \$67 in the six months ended June 30, 2004 compared to other expense, net of \$236 in the six months ended June 30, 2003. The other income, net for the six months ended June 30, 2004 is primarily attributed to the recovery from an insurance claim filed in 2003 for business interruption. The other expense, net for the six months ended June 30, 2003 is primarily attributed to unrealized foreign exchange losses on United States dollar receivables and cash held in our Canadian subsidiary, where the functional currency is the Canadian dollar.

Income Taxes

We recorded income tax expense of \$1,831 in the six months ended June 30, 2004 and \$489 in the six months ended June 30, 2003. The increase is attributed to our estimated domestic and international effective rate of 39%, which has been applied to the six months ended June 30, 2004, compared to the 15% rate applied to the six months ended June 30, 2003. The 2003 effective tax was benefited by the reduction of valuation allowances associated with net operating loss and tax credit carryforwards.

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LIQUIDITY AND CAPITAL RESOURCES (in thousands, except for share data)

Operating Cash Flows

Cash provided by operating activities was \$5,474 in the six months ended June 30, 2004 compared to \$4,924 in the in the six months ended June 30, 2003. Our positive operating cash flow in the six months ended June 30, 2004 was due primarily to net income of \$2,851, depreciation and amortization expense of \$1,665, a decrease in net deferred income taxes of \$1,033 and an increase in deferred revenue and billings in excess of revenues of \$720, offset by a \$413 increase in accounts receivable, a \$185 increase in prepaid assets, and a decrease of \$186 in accounts payable.

The total days sales outstanding for the six months ended June 30, 2004 remained relatively consistent at 91 days compared to 88 days for the six months ended June 30, 2003.

Although we anticipate recording income tax expense using a 39% effective income tax rate in 2004, the cash flow impact is expected to be less, due to tax benefits associated with utilizing net operating losses, tax credits and tax deductions associated with certain stock option exercises or disqualifying sales of Common Stock associated with stock options.

Investing Cash Flows

Cash used in investing activities was \$2,126 in the six months ended June 30, 2004, due to cash outflows for capitalized software development costs of \$1,873 and purchases of capital equipment of \$253. We expect to continue to invest in software development projects to increase sales.

Financing Cash Flows

Cash provided by financing activities was \$491 in the six months ended June 30, 2004. We received net proceeds of \$454 from employee and director stock option exercises and \$37 from purchases of our Common Stock by employees under our employee stock purchase plan.

Total outstanding commitments at June 30, 2004 were as follows:

| Contractual Obligations | Total | Less than 1 Year | 1 - 3 Years | 4 - 6 Years |
|---|----------|---------------------|----------------|----------------|
| ----- | ----- | ----- | ----- | ----- |
| Short-term debt..... | \$ 225 | \$ 225 | \$ ---- | \$ ---- |
| Operating leases..... | 3,304 | 720 | 1,243 | 779 |
| | ----- | ----- | ----- | ----- |
| Total contractual cash obligations..... | \$ 3,529 | \$ 945 | \$ 1,243 | \$ 779 |

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We also have a liability recorded of \$5 for put options on the remaining 1,000 of 420,000 exchangeable shares of eFilm, formerly known as Merge Technologies Canada Ltd., further formerly known as Interpra Medical Imaging Network Ltd. ("Interpra exchangeable shares"), which may be exercised for a price of \$4.50 per share during the period from August 31, 2004 until September 30, 2004.

In November 2003, we negotiated a new unsecured revolving line of credit agreement with our bank, increasing our line to \$15 million from \$5 million effective November 21, 2003, and maturing December 31, 2006. The interest rate on the line of credit is at a variable rate that is equal to the prime rate as published in The Wall Street Journal, less 0.75 percentage points. At June 30, 2004, the loan's interest rate was 3.25%. No amounts were outstanding on the line of credit as of June 30, 2004.

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

We believe that existing cash, together with the availability under our revolving line of credit and future cash flows from operations will be sufficient to execute our business plan in 2004. However, any projections of future cash inflows and outflows are subject to uncertainty. In 2004, it may be necessary to raise additional capital for activities necessary to meet our business objectives or our long-term liquidity needs. If it is determined that additional capital is needed, it may be raised by selling additional equity or raising debt from third party sources. The sale of additional equity or convertible debt securities could result in dilution to current stockholders. In addition, debt financing, if available, could involve restrictive covenants, which could adversely affect operations. There can be no assurance that any of these financing alternatives, including raising additional capital, will be available in amounts or on terms acceptable to us.

CRITICAL ACCOUNTING POLICIES

Our consolidated financial statements are impacted by the accounting policies used and the estimates and assumptions made by management during their preparation. Critical accounting policies in which management makes significant estimates are revenue recognition, accounts receivable, software capitalization, goodwill and intangible asset valuation, other long-lived assets and income taxes.

Revenue Recognition

Revenues are derived primarily from the sublicensing and licensing of computer software, installations, training, consulting, software maintenance and sales of PACS, RIS and RIS/PACS solutions. Inherent in the revenue recognition process are significant management estimates and judgments, which influence the timing and amount of revenue recognized.

For software arrangements, we recognize revenue according to the American Institute of Certified Public Accountants ("AICPA") Statement of Position No. 97-2, Software Revenue Recognition, and related amendments ("SOP No. 97-2"). SOP No. 97-2, as amended, generally requires revenue

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earned on software arrangements involving multiple elements to be allocated to each element based on the relative fair values of those elements. Revenue from multiple-element software arrangements is recognized using the residual method, pursuant to Statement of Position No. 98-9, Modification of SOP No. 97-2, Software Revenue Recognition, With Respect to Certain Transactions. Under the residual method, revenue is recognized in a multiple element arrangement when vendor-specific objective evidence of fair value exists for all of the undelivered elements in the arrangement, but does not exist for one or more of the delivered elements in the arrangement. We allocate revenue to each undelivered element in a multiple element arrangement based on its respective fair value, with the fair value determined by the price charged when that element is sold separately. Specifically, we determine the fair value of the maintenance portion of the arrangement based on the renewal price of the maintenance offered to customers, which is stated in the contract, and fair value of the installation based upon the price charged when the services are sold separately. If evidence of the fair value cannot be established for undelivered elements of a software sale, the entire amount of revenue under the arrangement is deferred until these elements have been delivered or vendor-specific objective evidence of fair value can be established.

Revenue from sales of RIS and from RIS/PACS solutions sold directly to customers, where professional services are considered essential to the functionality of the solution sold, is recognized on a percentage-of-completion method, as prescribed by AICPA Statement of Position 81-1, Accounting for Performance on Construction-Type and Certain Production-Type Contracts. Percentage-of-completion is determined by the input method based upon the amount of labor hours expended compared to the total estimated amount of labor hours to complete the project. Total estimated labor hours is based on management's best estimate of the total amount of time it takes to complete a project. These estimates require the use of judgment. A significant change in one or more of these estimates could affect the profitability of one or more of our contracts. We review our contract estimates periodically to assess revisions in contract values and estimated labor hours expended and reflect changes in estimates in the period that such estimates are revised under the cumulative catch-up method.

Revenue from sublicenses sold on an individual basis and computer software licenses is recognized upon shipment provided that evidence of an arrangement exists, delivery has occurred and risk of loss has passed to the customer, fees are fixed or determinable and collection of the related receivable is reasonably assured.

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

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

Accounts Receivable

Our accounts receivable balance is reported net of an allowance for bad debts. Our management determines collection risk and records allowances

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for bad debts based on the aging of accounts and past transaction history with customers. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.

Software Capitalization

Software capitalization commences when management determines that projects have achieved technological feasibility. Management's determination that a project has achieved technological feasibility does not ensure that the project can be commercially salable. Amounts capitalized include direct labor and estimates of overhead attributable to the projects. The useful lives of capitalized software projects are assigned by management, based upon the expected life of the software. Management also estimates the realizability of capitalized values based on projections of future net operating cash flows through the sale of products related to each capitalized project. If we determine in the future that the value of capitalized software cannot be recovered, a write-down of the value of the capitalized software to its recoverable value may be required. If the actual achieved revenues are lower than our estimates or the useful life of a project is shorter than the estimated useful life, the asset may be deemed to be impaired and, accordingly, a write-down of the value of the asset or a shorter amortization period may be required.

Other Long-Lived Assets

Other long-term assets, including property and equipment, and other intangibles, are amortized over their expected lives, which are estimated by management. Management also makes estimates of the impairment of long-term assets whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If the actual useful life of a long-term asset is shorter than the useful life estimated by us, the assets may be deemed to be impaired and, accordingly, a write-down of the value of the assets may be required.

Goodwill and Other Intangible Assets

Effective January 1, 2002, we adopted SFAS No. 142, Goodwill and Other Intangible Assets ("SFAS No. 142"). SFAS No. 142 requires that goodwill and indefinite lived intangible assets be reviewed for impairment annually, or more frequently if impairment indicators arise. Our policy provides that goodwill and indefinite lived intangible assets will be reviewed for impairment as of December 31 of each year. In calculating potential impairment losses, we evaluated the fair value of goodwill and intangible assets by estimating the expected present value of their future cash flows. The future cash flows are based upon management's assumptions about future sales activity and market acceptance of our products. If these assumptions change, we may be required to write down the carrying value to a revised amount.

Income Taxes

As part of the process of preparing our consolidated financial statements, we are required to estimate income taxes in each of the

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jurisdictions in which we operate. This process involves estimating our current tax rate together with assessing temporary differences resulting from differing treatment of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities. Significant management judgment is required in determining our provision for income taxes, deferred tax assets and liabilities.

FACTORS THAT MAY AFFECT FUTURE RESULTS OF OPERATIONS, FINANCIAL CONDITION OR BUSINESS

Quarterly Operating Results May Vary - Our quarterly operating results have varied in the past and may continue to vary in future periods. Quarterly operating results may vary for a number of reasons, including accounting policy changes mandated by regulating entities (including, but not limited to, any accounting policy change concerning the expensing of options), demand for our software solutions and services, our sales cycle, and other factors described in this section and elsewhere in this report. As a result of healthcare industry trends and the market for our RIS, PACS or RIS/PACS solutions, a large percentage of our revenues are generated by the sale and installation of systems sold directly to healthcare institutions. The sale may be subject to delays due to clients' internal budgets and procedures for approving capital expenditures and by competing needs for other capital expenditures and deploying new technologies or personnel resources. Delays in the expected sale or installation of these contracts may have a significant impact on our anticipated quarterly revenues and consequently our earnings, since a significant percentage of our expenses are relatively fixed.

In addition, software revenue from sales of PACS solutions are generally recognized at the time of shipment to our customers. Software revenue from sales of RIS and RIS/PACS solutions are recognized on the percentage-of-completion method as the installation services are performed. As a result, significant changes in the sales mix of our FUSION(tm) solutions may have an impact on our quarterly revenues and consequently, our earnings.

Stock Price May Be Volatile - The trading price of our Common Stock may be volatile. The market for our Common Stock may experience significant price and volume fluctuations in response to a number of factors including actual or anticipated quarterly variations in operating results, rumors about our performance or software solutions, changes in expectations of future financial performance or changes in estimates of securities analysts, governmental regulatory action, healthcare reform measures, client relationship developments, changes occurring in the securities markets in general and other factors, many of which are beyond our control. As a matter of policy, we do not generally comment on rumors.

Furthermore, the stock market in general, and the market for software, healthcare and technology companies in particular, has experienced volatility that often has been unrelated to the operating performance of particular companies. These broad market and industry fluctuations may adversely affect the trading price of our Common Stock, regardless of actual operating performance.

Changes in the Healthcare Industry - The healthcare industry is highly regulated and is subject to changing political, economic and regulatory influences. For example, the Health Insurance Portability and Accountability Act of 1996 (HIPAA) will impact the healthcare industry by requiring identifiers and standardized transactions/code sets and necessary security and privacy measures in order to ensure the protection of patient health information. These factors affect the purchasing practices and operation of healthcare organizations. Federal and state legislatures have periodically considered programs to reform the United States of America healthcare system at both the federal and state level and to change healthcare financing and

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reimbursement systems. These programs may contain proposals to increase governmental involvement in healthcare, lower reimbursement rates or otherwise change the environment in which healthcare industry participants operate. Healthcare industry participants may respond by reducing their investments or postponing investment decisions, including investments in our software solutions and services.

Significant Competition - The market for RIS, PACS and RIS/PACS systems is competitive and subject to technological change. We believe that the principal competitive factors in this market include the breadth and quality of system and software solution offerings, the stability of the systems

provider, the features and capabilities of the information system, the ongoing support for the system and the potential for enhancements and future compatible software solutions. Certain of our competitors have greater financial, technical, product development, marketing and other resources than us and some of our competitors offer software solutions that we do not offer.

Proprietary Technology May Be Subjected to Infringement Claims or May Be Infringed Upon - We rely upon a combination of license agreements, confidentiality procedures, employee nondisclosure agreements and technical measures to maintain the confidentiality and trade secrecy of our proprietary information. We also rely on trademark and copyright laws to protect our intellectual property. We currently have a very limited patent portfolio. As a result, we may not be able to protect against misappropriation of our intellectual property.

In addition, we could be subject to intellectual property infringement claims as the number of competitors grow and the functionality of our software solutions and services overlap with competitive offerings. These claims, even if not meritorious, could be expensive to defend. If we become liable to third parties for infringing their intellectual property rights, we could be required to pay a substantial damage award and to develop noninfringing technology, obtain a license or cease selling the software solutions that contain the infringing intellectual property.

Dependence on Key Employees - Our continued success will depend to a significant degree upon the efforts and abilities of our senior management, in particular, Richard A. Linden, our President and Chief Executive Officer. We carry key man life insurance in the amount of \$5,000,000 on Richard A. Linden and \$2,000,000 on Scott T. Veech, our Chief Financial Officer. We do not carry key man life insurance on any other of our officers or directors. The loss of the services of any of these persons could have a material adverse effect on us.

Government Regulation - We are subject to regulation by the Federal Drug Administration ("FDA"). If our software solutions are deemed to be actively regulated medical devices by the FDA, we could be subject to more extensive requirements governing pre- and post-marketing requirements. Complying with these FDA regulations could be time consuming and expensive. It is possible that the FDA may become more active in regulating computer software that is used in healthcare.

Following an inspection by the FDA in November of 2003, we received a FDA warning letter and Form 483 (Notice of Inspectional Observations) listing observations of non-compliance with certain aspects of the FDA's Quality System Regulation. We responded to the FDA on February 5, 2004, and undertook a number of corrective actions in response to the Form 483 and the FDA warning

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letter.

There can be no assurance, however, that our actions taken in response to the Form 483 and warning letter will be deemed adequate by the FDA or that additional actions will not be required by us. In addition, we remain subject to periodic FDA inspections and there can be no assurances that we will not be required to undertake additional actions to comply with the Federal Food, Drug and Cosmetic Act ("Act") and any other applicable regulatory requirements. Any failure by us to comply with the Act and any other applicable regulatory requirements could have a material adverse effect on our ability to continue to manufacture and distribute our software solutions. The FDA has many enforcement tools including recalls, seizures, injunctions, civil fines and/or criminal prosecutions. Any of the foregoing could have a material adverse effect on our business, results of operations or financial condition.

Product Related Liabilities - Many of our software solutions provide data for use by healthcare providers in providing care to patients. Although no such claims have been brought against us to date regarding injuries related to the use of our software solutions, such claims may be made in the future. Although we maintain product liability insurance coverage in an amount that we believe is sufficient for our business, there can be no assurance that such coverage will cover a particular claim that may be brought in the future, prove to be adequate or that such coverage will continue to remain available on acceptable terms, if at all. A successful claim brought against us, which is uninsured or underinsured, could materially harm our business, results of operations or financial condition.

Risks Associated with Our Global Operations - We market, sell and service our software solutions globally. We have established offices around the world, including North America, the Netherlands and Japan. We will continue to expand our global operations and enter new global markets. This expansion will require significant management attention and financial

resources to develop successful indirect global sales and support channels. Our success will depend, in part, on our ability to form relationships with local partners. For these reasons, we may not be able to maintain or increase global market demand for our software solutions.

Global operations are subject to inherent risks, and our future results could be adversely affected by a variety of uncontrollable and changing factors. These include:

- * Greater difficulty in collecting accounts receivable and longer collection periods.
- * The impact of economic conditions outside the United States of America.
- * Changes in foreign currency exchange.
- * Unexpected changes in regulatory requirements.
- * Certification requirements.
- * Reduced protection of intellectual property rights in some countries.
- * Potentially adverse tax consequences.

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- * Political instability.
- * Trade protection measures and other regulatory requirements.
- * Service provider and government spending patterns.
- * Natural disasters, war or terrorist acts.
- * Poor selection of a partner in a country.
- * Political conditions which may threaten the safety of associates or our continued presence in foreign countries.

Concentrations - Substantially all of our cash and cash equivalents is held at one United States of America financial institution. Deposits held with the bank exceed the amount of insurance provided on such deposits. Generally these deposits may be redeemed upon demand and, therefore, bear minimal risk. Substantially all of our clients are imaging centers, hospitals and integrated delivery networks. If significant adverse macro-economic factors were to impact these organizations, it could materially adversely affect us. Our access to certain software and hardware components is dependent upon single and sole source suppliers. The inability of any supplier to fulfill our supply requirements could affect future results.

MATERIAL OFF BALANCE SHEET ARRANGEMENTS

We have no material off balance sheet arrangements.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Interest Rate Risk. Our cash equivalents are exposed to financial market risk due to fluctuations in interest rates, which may affect our interest income. As of June 30, 2004, our cash equivalents and short-term investments include money market funds and short term deposits totaling \$19,489, and earned interest at a weighted average rate of 0.6%. The value of the principal amounts are equal to the fair value for these instruments. Due to the relative short-term nature of our investment portfolio, our interest income is vulnerable to sudden changes in market interest rates. We do not use our portfolio for trading or other speculative purposes.

Foreign Currency Exchange Risk. We have sales and expenses in Canada and Europe that are denominated in currencies other than the United States dollar and as a result have exposure to foreign currency exchange risk. We do not currently enter into forward exchange contracts to hedge exposures denominated in foreign currencies or any other derivative financial instruments for trading or speculative purposes. However, in the event our exposure to foreign currency risk increases to levels that we do not deem acceptable, we may choose to hedge those exposures.

ITEM 4. CONTROLS AND PROCEDURES

Our Chief Executive Officer and Chief Financial Officer have concluded, based on their evaluation as of a date within 90 days prior to the filing date of this report, that our disclosure controls and procedures are effective for gathering, analyzing and disclosing the information we are required to disclose

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in our reports filed under the Exchange Act. There have been no significant changes in our internal controls or in other factors that could significantly affect these controls subsequent to the date of the previously mentioned evaluation.

INTERNAL CONTROL OVER FINANCIAL REPORTING

There have not been any changes in our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II

ITEM 1. LEGAL PROCEEDINGS

On October 24, 2003, ScheduleQuest, Inc. filed a patent infringement lawsuit (Civil Action No. 03-5900) against us in the United States District Court for the Eastern District of Pennsylvania alleging that our "RIS Logic CS Scheduling System" product infringes upon their United States of America Patent No. 6,389,454 for their "Multi-Facility Appointment Scheduling System" product. We cannot currently predict the outcome of the litigation or the amount of any potential loss if our defense is unsuccessful. Our merger agreement with RIS Logic contains a representation that the RIS Logic technology does not infringe others' proprietary rights and 173,093 shares of our Common Stock conveyed to the former RIS Logic owners are in an escrow holdback to cover any claims of breach of representation or warranty. We believe that all the claims in the lawsuit are without merit and we intend to vigorously defend against such claims. However, we cannot provide any assurances as to the outcome of this litigation or whether the escrow holdback will be adequate to satisfy any costs, expenses or losses that we may incur in connection with such litigation.

ITEM 2. CHANGES IN SECURITIES, USE OF PROCEEDS AND ISSUER PURCHASES OF EQUITY SECURITIES

In the three months ended June 30, 2004, we sold no shares of our Common Stock in transactions that were not registered under the Securities Act.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not applicable.

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

Our Annual Meeting of Shareholders was held on May 20, 2004. Matters voted on and the results of such votes are listed below.

Votes
Against or

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| | Votes For ----- | Withheld ----- | Abstained ----- |
|--|--------------------|-------------------|--------------------|
| Elect William C. Mortimore to serve as Director until the next annual meeting of Shareholders..... | 9,299,550 | 992,665 | ---- |
| Elect Robert A. Barish, M.D. to serve as Director until the next annual meeting of Shareholders..... | 10,012,232 | 279,983 | ---- |
| Elect Dennis Brown to serve as Director until the next annual meeting of Shareholders..... | 10,012,232 | 279,983 | ---- |
| Elect Michael D. Dunham to serve as Director until the next annual meeting of Shareholders..... | 10,012,232 | 279,983 | ---- |
| Elect Robert T. Geras to serve as Director until the next annual meeting of Shareholders..... | 10,012,232 | 279,983 | ---- |
| Elect Anna M. Hajek to serve as Director until the next annual meeting of Shareholders..... | 10,010,953 | 281,262 | ---- |
| Elect Richard A. Linden to serve as Director until the next annual meeting of Shareholders..... | 10,012,232 | 279,983 | ---- |
| Elect Richard A. Reck to serve as Director until the next annual meeting of Shareholders..... | 9,071,719 | 1,220,496 | ---- |
| Elect Frank E. Seidelmann, D. O. to serve as Director until the next annual meeting of Shareholders..... | 10,012,232 | 279,983 | ---- |

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

See Exhibit Index.

(b) On April 29, 2004, we filed a Form 8-K to report in Item 12, press release announcing financial results for the first quarter of our fiscal year 2004.

SIGNATURES

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In accordance with the requirements of the Securities Exchange Act of 1934, the Registrant caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized.

Registrant:

MERGE TECHNOLOGIES INCORPORATED

August 6, 2004

By: /s/ Richard A. Linden

Richard A. Linden
President and Chief Executive Officer

August 6, 2004

By: /s/ Scott T. Veech

Scott T. Veech
Chief Financial Officer, Secretary
and Treasurer (Principal Financial
Officer and Principal Accounting
Officer)

EXHIBIT INDEX

- 2.1 Purchase Agreement, dated as of September 1, 1999, by and among Merge Technologies Incorporated, 3032854 Nova Scotia Company and Interpra Medical Imaging Network Ltd.(11)
- 2.2 Reorganization Agreement between Merge Technologies Incorporated, Merge Technologies Holdings Co., eFilm Medical Inc., Patrice Bret, Gregory Couch and Catherine McCallum, dated as of April 15, 2002(13)
- 2.3 Merger Agreement by and among Merge Technologies Incorporated, RL Acquisition Corp, RIS Logic Incorporated, and the Principal Shareholders of RIS Logic Incorporated dated July 9, 2003(14)
- 3.1 Articles of Incorporation of Registrant(2), Articles of Amendment as filed on December 28, 1998(3), Articles of Amendment as filed on September 2, 1999(6), Articles of Amendment as filed on February 23, 2001(6), and Articles of Amendment as filed on August 9, 2002(15)
- 3.2 Amended and Restated Bylaws of Registrant as of February 3, 1998(1)
- 10.1 Employment Agreement entered into as of March 1, 2004, between Registrant and Richard A. Linden(15)
- 10.2 Employment Agreement entered into as of March 1, 2004, between Registrant and William C. Mortimore(15)
- 10.3 Employment Agreement entered into as of March 1, 2004, between Registrant and Scott T. Veech(15)
- 10.4 Employment Agreement entered into as of March 1, 2004, between Registrant and David M. Noshay(15)

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- 10.5 1996 Stock Option Plan for Employees of Registrant dated May 13, 1996(2), as amended and restated in its entirety as of September 1, 2003(10)
- 10.6 Office Lease for West Allis Center dated May 24, 1996, between Registrant and Whitnall Summit Company, LLC, Supplemental Office Lease dated July 3, 1997(1), Supplemental Office Space Lease dated January 30, 1999(2), Supplemental Office Space Lease for 1126 West Allis Operating Associates Limited Partnership dated April 11, 2000(4) and Second Amendment to Lease dated January 11, 2002, between Registrant and 1126 West Allis Operating Associates, Limited Partnership(7)
- 10.7 1998 Stock Option Plan For Directors(1)
- 10.8 2003 Stock Option Plan of Registrant dated June 24, 2003, and effective July 17, 2003(10)
- 10.9 Merge Technologies Incorporated 2000 Employee Stock Purchase Plan, as amended(5)
- 10.10 Loan Agreement dated as of November 21, 2003, by and between Registrant and Lincoln State Bank(15)
- 10.11 Asset Purchase Agreement by and among Signal Stream, Inc., a wholly owned subsidiary of Merge Technologies Incorporated, and Aurora Technology Inc., entered into as of April 18, 2002(12)
- 31.1 Certification of Chief Executive Officer Pursuant to Section 13(a) of the Securities Exchange Act of 1934
- 31.2 Certification of Chief Financial Officer Pursuant to Section 13(a) of the Securities Exchange Act of 1934
- 32 Certification of Chief Executive Officer and Chief Financial Officer Pursuant to Section 13(a) of the Securities Exchange Act of 1934 (Section 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes - Oxley Act of 2002)
- 99.1 Code of Ethics(15)
- 99.2 Whistleblower Policy(15)
-
- (1) Incorporated by reference from Annual Report on Form 10-KSB for the fiscal year ended December 31, 1997.
- (2) Incorporated by reference from Registration Statement on Form SB-2 (No. 333-39111) effective January 29, 1998.
- (3) Incorporated by reference from Quarterly Report on Form 10-QSB for the three months ended June 30, 1999.
- (4) Incorporated by reference from Quarterly Report on Form 10-QSB for the three months ended June 30, 2000.
- (5) Incorporated by reference from Proxy Statement for 2000 Annual Meeting of Shareholders dated May 9, 2000.
- (6) Incorporated by reference from Annual Report on Form 10-KSB for the fiscal year ended December 31, 2000.

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- (7) Incorporated by reference from Annual Report on Form 10-KSB for the fiscal year ended December 31, 2001.
- (8) Incorporated by reference from Annual Report on Form 10-KSB for the fiscal year ended December 31, 2002.
- (9) Incorporated by reference from Quarterly Report on Form 10-Q for the three months ended June 30, 2003.
- (10) Incorporated by reference from Quarterly Report on Form 10-Q for the three months ended September 30, 2003.
- (11) Incorporated by reference from Current Report on Form 8-K dated September 3, 1999.
- (12) Incorporated by reference from Current Report on Form 8-K dated May 22, 2002.
- (13) Incorporated by reference from Current Report on Form 8-K dated June 28, 2002.
- (14) Incorporated by reference from Current Report on Form 8-K dated July 17, 2003.
- (15) Incorporated by reference from Annual Report on Form 10-K for the fiscal year ended December 31, 2003.

EXHIBIT 31.1

CERTIFICATION

Pursuant to Section 302 of the Sarbanes - Oxley Act of 2002

I, Richard A. Linden, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Merge Technologies Incorporated (the "Registrant");
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the Registrant as of, and for, the periods presented in this quarterly report;
4. The Registrant's other certifying officer and I (herein, the "Certifying Officers") are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the Registrant and have:

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- (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Registrant, including its consolidated subsidiaries (collectively, the "Company"), is made known to the Certifying Officers by others within the Company, particularly during the period in which this quarterly report is being prepared; and
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles; and
 - (c) Evaluated the effectiveness of the Registrant's disclosure controls and procedures and presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this quarterly report based on such evaluation; and
 - (d) Disclosed in this quarterly report any change in the Registrant's internal control over financial reporting that occurred during the Registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Registrant's internal control over financial reporting; and
5. The Registrant's Certifying Officers have disclosed, based on the Certifying Officers' most recent evaluation of internal control over financial reporting, to the Registrant's auditors and the Audit Committee of the Registrant's Board of Directors:
- (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the Registrant's internal control over financial reporting.

Date: August 6, 2004

/s/ Richard A. Linden

Richard A. Linden, Chief Executive Officer

See also the certification pursuant to Section 906 of the Sarbanes - Oxley Act of 2002, which is included as an exhibit to this report.

EXHIBIT 31.2

CERTIFICATION
Pursuant to Section 302 of the Sarbanes - Oxley Act of 2002

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I, Scott T. Veech, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Merge Technologies Incorporated (the "Registrant");
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the Registrant as of, and for, the periods presented in this quarterly report;
4. The Registrant's other certifying officer and I (herein, the "Certifying Officers") are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the Registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Registrant, including its consolidated subsidiaries (collectively, the "Company"), is made known to the Certifying Officers by others within the Company, particularly during the period in which this quarterly report is being prepared; and
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles; and
 - (c) Evaluated the effectiveness of the Registrant's disclosure controls and procedures and presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this quarterly report based on such evaluation; and
 - (d) Disclosed in this quarterly report any change in the Registrant's internal control over financial reporting that occurred during the Registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Registrant's internal control over financial reporting; and
5. The Registrant's Certifying Officers have disclosed, based on the Certifying Officers' most recent evaluation of internal control over financial reporting, to the Registrant's auditors and the Audit Committee of the Registrant's Board of Directors:
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Registrant's ability to record, process, summarize and

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report financial information; and

- (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the Registrant's internal control over financial reporting.

Date: August 6, 2004

/s/ Scott T. Veech

Scott T. Veech, Chief Financial Officer

See also the certification pursuant to Section 906 of the Sarbanes - Oxley Act of 2002, which is included as an exhibit to this report.

EXHIBIT 32

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

In connection with the Quarterly Report on Form 10-Q of MERGE TECHNOLOGIES INCORPORATED (the "Company") for the quarterly period ended June 30, 2004, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), Richard A. Linden, as Chief Executive Officer of the Company, and Scott T. Veech, as Chief Financial Officer of the Company, each hereby certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes - Oxley Act of 2002, that, to the best of their knowledge:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: August 6, 2004

By: /s/ Richard A. Linden

Richard A. Linden
Chief Executive Officer

Date: August 6, 2004

By: /s/ Scott T. Veech

Scott T. Veech
Chief Financial Officer

This certification accompanies the Report pursuant to Section 906 of the Sarbanes - Oxley Act of 2002 and shall not, except to the extent required by the Sarbanes - Oxley Act of 2002, be deemed filed by the Company for purposes

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of Section 18 of the Securities Exchange Act of 1934, as amended.

See also the certifications pursuant to Section 302 of the Sarbanes - Oxley Act of 2002, which are included in this quarterly report on Form 10-Q.