FORMFACTOR INC
Form 8-K
March 26, 2008

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 8-K

CURRENT REPORT
Pursuant to Section 13 or 15(d)
of the Securities Exchange Act of 1934

Date of Report (Date of earliest event reported): **March 21, 2008**

FORMFACTOR, INC.

(Exact name of Registrant as specified in its charter)

Delaware
(State or other jurisdiction of incorporation)

000-50307 (Commission File Number)		**13-3711155** (IRS Employer Identification No.)
	7005 Southfront Road, Livermore, CA (Address of principal executive offices)	**94551** (Zip Code)

(925) 290-4000

(Registrant s telephone number, including area code)

Not Applicable

(Former name or former address, if changed since last report)

Check the appropriate box below if the Form 8-K filing is intended to simultaneously satisfy the filing obligation of the Registrant under any of the following provisions (See General Instruction A.2.):

o Written communications pursuant to Rule 425 under the Securities Act (17 CFR 230.425)

o Soliciting material pursuant to Rule 14a-12 under the Exchange Act (17 CFR 240.14a-12)

o Pre-commencement communications pursuant to Rule 14d-2(b) under the Exchange Act (17 CFR 240.14d-2(b))

o Pre-commencement communications pursuant to Rule 13e-4(c) under the Exchange Act (17 CFR 240.13e-4(c))

Item 5.02. Departure of Certain Officers; Compensatory Arrangements of Certain Officers.

On February 25, 2008, FormFactor, Inc. announced the resignation of Ronald C. Foster, its Chief Financial Officer and a Senior Vice President, to be effective after a transition period. Mr. Foster tendered his resignation effective as of March 21, 2008. In connection with his departure, FormFactor and Mr. Foster entered into a separation agreement and general release under which the company agreed to provide Mr. Foster a severance payment of $232,500, reimbursement of health benefits continuation coverage under COBRA through December 2008, and accelerated vesting of a portion of his stock options, representing options for an aggregate of 66,027 shares, with all vested shares exercisable until September 20, 2009. Mr. Foster signed a general release and waiver of claims in favor of the company, and continues to be bound by the company s employment, confidential information and invention assignment agreement. In addition, Mr. Foster agreed to be available to assist with facilitating the transition surrounding the company s hiring of a new chief financial officer.

Item 9.01. Exhibits.

Exhibit Number	Exhibit Title or Description
10.01	Separation Agreement and General Release with Ronald C. Foster.

SIGNATURE

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

Date: March 26, 2008	**FORMFACTOR, INC.**	
	By:	/s/ STUART L. MERKADEAU Stuart L. Merkadeau Senior Vice President, General Counsel and Secretary

EXHIBIT INDEX

Exhibit Number	Exhibit Title or Description
10.01	Separation Agreement and General Release with Ronald C. Foster.

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Purchases of property and equipment with accounts payable		
$	308,053	
$	300,755	
$	227,755	

Non-cash investing and financing activities:

Common stock issued for acquisition of HInnovation, Inc.

$

$

6,109,554

$

The accompanying notes are an integral part of the consolidated financial statements.

Vital Images, Inc.

Notes to Consolidated Financial Statements

1. Business description

Vital Images, Inc. (the Company) develops, markets and supports enterprise-wide advanced visualization software for use primarily in clinical analysis and therapy planning. The Company s software applies proprietary computer graphics and image processing technologies to a wide variety of data supplied by computed tomography (CT), magnetic resonance (MR) and positron emission tomography (PET) scanners. The Company s products allow clinicians to create 2D, 3D and 4D views of human anatomy and to non-invasively navigate within these images to better visualize and understand internal structures and pathologies. The Company believes that its high-speed visualization technology and customized protocols cost-effectively bring 3D visualization and analysis into the routine, day-to-day practice of medicine.

The Company views its operations and manages its business as one reportable segment the development and marketing of software and related services for enterprise-wide advanced visualization and analysis solutions for use by medical professionals in clinical analysis and therapy planning. Factors used to identify the Company s single operating segment include the financial information available for evaluation by the chief operating decision maker in making decisions about how to allocate resources and assess performance. The Company markets its products and services through a direct sales force and independent distributors in the United States and international markets.

The Company is subject to risks and uncertainties, including dependence on information technology spending by customers, well-established competitors, concentration of clients in a limited number of industries, fluctuations of quarterly results, a lengthy and variable sales cycle, dependence on principal products and third-party technology, rapid technological change, its ability to develop products that gain market acceptance and international expansion.

2. Summary of significant accounting policies

Basis of presentation

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary, HInnovation, Inc. All intercompany accounts and transactions have been eliminated.

Use of estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Fair value of financial instruments

The Company s financial instruments consist primarily of cash, cash equivalents, and marketable securities, for which the current carrying amounts approximate fair market values.

Cash and cash equivalents

Cash and cash equivalents consist of cash and temporary investments with maturities of 90 days or less when purchased. The carrying amount of cash equivalents approximates fair value due to the short maturity of these instruments.

Marketable securities

Management determines the appropriate classification of marketable securities at the time of purchase and reevaluates such designation as of each balance sheet date. Currently, all marketable securities held by the Company are classified as available-for-sale. Available-for-sale securities are carried at fair value as determined by quoted market prices, with unrealized gains and losses, net of tax, reported as a separate component of stockholders equity. If an unrealized loss for any investment is considered to be other-than-temporary, the loss will be recognized in the consolidated statements of operations in the period the determination is made. The cost basis of securities sold is determined using the specific identification method. The cost of marketable securities is adjusted for amortization of premiums and accretion of discounts to maturity. Such amortization and accretion is included in interest income. Interest and dividends on securities classified as available-for-sale are included in interest income. As of December 31, 2005, all investments mature within one year.

As of December 31, 2005 and 2004, the Company s marketable securities were as follows:

	December 31, 2005			December 31, 2004		
	Cost Basis	Aggregate Fair Value	Net Unrealized Losses	Cost Basis	Aggregate Fair Value	Net Unrealized Losses
Corporate debt	$ 27,998,057	$ 27,970,349	$ (27,708)	$ 10,596,591	$ 10,553,290	$ (43,301)
Certificates of deposit	999,401	994,980	(4,421)	997,414	992,850	(4,564)
	$ 28,997,458	$ 28,965,329	$ (32,129)	$ 11,594,005	$ 11,546,140	$ (47,865)

Accounts receivable and allowance for doubtful accounts

Accounts receivable are initially recorded at a selling price, which approximates fair value upon the sale of goods or services to customers. The Company maintains an allowance for doubtful accounts to reflect accounts receivable at net realizable value. In judging the adequacy of the allowance for doubtful accounts, the Company considers multiple factors, including historical bad debt experience, the general economic environment, the need for specific client reserves and the aging of the Company s receivables. This provision is included in general and administrative expense in the consolidated statements of operations. A considerable amount of judgment is required in assessing these factors. If the factors utilized in determining the allowance do not reflect future performance, then a change in the allowance for doubtful accounts would be necessary in the period such determination has been made, which would impact future results of operations.

Concentration of credit risk

Financial instruments that potentially subject the Company to concentrations of credit risk consist primarily of cash and cash equivalents and trade accounts receivable. Deposits with the Company s bank may exceed the amount of insurance provided on such deposits. Generally, these deposits may be redeemed upon demand and, therefore, bear minimal risk. Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of marketable securities. Marketable securities consist of corporate debt and certificates of deposit. The Company s investment policy, approved by the Board of Directors, limits the amount the Company may invest in any one type of investment, thereby reducing credit risk concentrations. The Company s customer base is generally concentrated with a small number of customers. The Company reviews the creditworthiness of its customers prior to product shipment and generally does not require collateral.

Property and equipment

Property and equipment are recorded at cost. Depreciation is computed using the straight-line method over the related asset s estimated useful life, generally three to seven years. Leasehold improvements are amortized over the shorter of their estimated useful lives or the remaining terms of the related leases. The asset cost and related accumulated depreciation or amortization are adjusted for asset retirement or disposal with the resulting gain or loss, if any, credited or charged to results of operations.

Long-lived assets

The Company reviews long-lived assets for impairment whenever events or changes in circumstances indicate the carrying amount may not be recoverable, in accordance with Statement of Financial Accounting Standards (SFAS) No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. Events or changes in circumstances that indicate the carrying amount may not be recoverable include, but are not limited to, a significant decrease in the market value of the business or asset acquired, a significant adverse change in the extent or manner in which the business or asset acquired is used, or a significant adverse change in the business climate. If such events or changes in circumstances are present, the undiscounted cash flows method is used to determine whether the asset is impaired. Cash flows would include the estimated terminal value of the asset and exclude any interest charges. To the extent the carrying value of the asset exceeds the undiscounted cash flows over the estimated remaining life of the asset, the impairment is measured using the discounted cash flows. The discount rate utilized would be based on management s best estimate of the related risks and return at the time the impairment assessment is made.

Goodwill

The Company accounts for goodwill in accordance with the provisions of SFAS No. 142, Goodwill and Other Intangible Assets . Under SFAS No. 142, goodwill and intangible assets with indefinite lives are reviewed for impairment annually or more frequently if events or changes in circumstances indicate that the asset might be impaired. The first step of the goodwill impairment test, used to identify potential impairment, compares the fair value of a reporting unit with its carrying amount, including goodwill. The Company operates as one reporting unit and therefore compares the book value to the market value (market capitalization plus a control premium). If the market value exceeds the book value, goodwill is considered not impaired, and thus the second step of the impairment test is not necessary. If the Company s book value exceeds the market value, the second step of the goodwill impairment test is performed to measure the amount of impairment loss, if any. The second step of the goodwill impairment test, used to measure the amount of impairment loss, compares the implied fair value of the goodwill with the book value of the goodwill. If the carrying value of the goodwill exceeds the implied fair value of the goodwill, an impairment loss would be recognized in an amount equal to the excess. Any loss recognized cannot exceed the carrying amount of goodwill. After a goodwill impairment loss is recognized, the adjusted carrying amount of goodwill is its new accounting basis. Subsequent reversal of a previously recognized goodwill impairment loss is prohibited once the measurement of that loss is completed. The Company completed the annual goodwill impairment assessment as of December 31, 2005, in which no impairment was recorded.

Revenue recognition

The Company recognizes revenue in accordance with American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) 97-2, Software Revenue Recognition, as amended by SOP 98-4 and SOP 98-9, as well as Technical Practice Aids issued from time to time by the AICPA, and SEC Staff Accounting Bulletin No. 104. The Company recognizes revenue when it is realized or realizable and earned. The Company considers revenue realized or realizable and earned when it has persuasive evidence of an arrangement, the product has been shipped or the services have been provided to the customer, the sales price is fixed or determinable, and collectability is probable. Provided all other revenue recognition criteria are met, license revenue from Resellers is recognized on a sell-in or sell-through basis depending on the arrangement with the Reseller. The Company recognizes revenue from Resellers on a sell-in basis provided the Reseller i) assumes all risk of the purchase, ii) has the ability and obligation to pay regardless of receiving payment from the end user, and iii) has a history of timely payments.

License fees revenue is derived from the licensing of computer software. Hardware revenue is derived from the sale of system hardware, including peripheral equipment. Maintenance and service revenue is derived from software maintenance and from telephone support, installation, training and consulting services. The Company s software licenses are always sold as part of an arrangement that includes maintenance and support and often installation and training services.

The Company licenses its software and sells products and services to end-users and also indirectly through original equipment manufacturers (OEMs) and independent distributors (collectively, Resellers). Terms offered by the Company do not generally differ based on whether the customer is an OEM, an end-user or a Reseller. The Company generally offers terms that require payment within 30 to 90 days after product delivery. In rare situations where the Company offers terms that require payment beyond 90 days after product delivery, revenue is deferred until the payment becomes due. The Company does not generally offer rights of return, acceptance clauses or price protection to its customers. In rare situations where the Company provides rights of return or acceptance clauses, revenue is deferred until the clause expires. The Company evaluates the credit worthiness of all customers. In circumstances in which the Company does not have experience selling to a customer and lacks adequate credit information to conclude that collection is probable, revenue is deferred until the arrangement fees are collected and all other revenue recognition criteria in the arrangement have been met. Additionally:

Software and Hardware Revenue from license fees and hardware is recognized when shipment of the product has occurred, no significant Company obligations with regard to implementation remain and the Company s services are not considered essential to the functionality of other elements of the arrangement.

Services Revenue from maintenance and support arrangements is deferred and recognized ratably over the term of the maintenance and support arrangements. Revenue from training, installation and consulting services is recognized as the services are provided to customers.

Multiple-Element Arrangements The Company enters into arrangements with customers that include a combination of software products, system hardware, specified upgrades, maintenance and support, or installation and training services. For such arrangements, the Company recognizes revenue using the residual value method. The Company allocates the total arrangement fee among the various elements of the arrangement based on the relative fair value of each of the undelivered elements determined by vendor-specific objective evidence. The fair value of maintenance and support services is based upon the renewal rate for continued service arrangements. The fair value of installation and training services is established based upon sold separately pricing for the services. In software arrangements for which the Company does not have vendor-specific objective evidence of fair value for all elements, revenue is deferred until the earlier of when vendor-specific objective evidence is determined for the undelivered elements (residual method) or when all elements for which the Company does not have vendor-specific objective evidence of fair value have been delivered.

Stock-based compensation

The Company has stock-based employee and director compensation plans, which are described more fully in Note 6. The Company accounts for stock-based employee compensation arrangements in accordance with the provisions of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees , and complies with the disclosure provisions of SFAS No. 123, Accounting for Stock-Based Compensation and SFAS No. 148, Accounting for Stock-Based Compensation-Transition and Disclosure-an amendment of Financial Accounting Standards Board (FASB) Statement No. 123.

The Company has adopted the disclosure-only provisions of SFAS No. 123. For purposes of the pro forma disclosures below, the estimated fair value of the options and restricted stock is amortized to expense over the vesting period. Shares used in the pro forma diluted earnings per share computation use the calculation methodology prescribed by SFAS No. 123, which is different from the shares used for the reported diluted earnings per share computation. Had compensation cost for the Company s stock options and restricted stock awards been recognized based on the fair value at the grant date consistent with the provisions of SFAS No. 123, the Company s net income would have been adjusted to the pro forma amounts indicated below:

	For the Year Ended December 31,		
	2005	**2004**	**2003**
Net income, as reported	$ 5,800,530	$ 295,563	$ 8,462,141
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects	199,133		
Deduct: Total stock-based employee compensation expense determined under fair value method for all awards, net of related tax effects	(2,077,953)	(2,155,282)	(1,387,174)
Pro forma net income (loss)	$ 3,921,710	$ (1,859,719)	$ 7,074,967
Net income (loss) per share - basic			
As reported	$ 0.47	$ 0.03	$ 0.83
Pro forma	$ 0.32	$ (0.16)	$ 0.69
Net income (loss) per share - diluted			
As reported	$ 0.44	$ 0.02	$ 0.71
Pro forma	$ 0.30	$ (0.16)	$ 0.62

The pro forma effects on net income for 2005, 2004 and 2003 are not representative of the pro forma effect that will occur on net income in future periods (see Note 2 schedule labeled New accounting pronouncement).

Research and development costs

Costs related to research, design and development of products are charged to research and development expense as incurred. Software development costs are capitalized beginning when a product s technological feasibility has been established and ending when a product is available for general release to customers. The Company uses the working model approach to determine technological feasibility. Generally, the Company s products are released soon after technological feasibility has been established. As a result, the Company has not capitalized any software development costs, since such costs have not been significant.

Income taxes

The Company provides for income taxes using the liability method under SFAS No. 109, Accounting for Income Taxes, which requires recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the financial statements. Under this statement, deferred tax assets and liabilities are determined based on the difference between the financial statement and tax basis of assets and liabilities, using enacted tax rates in effect for the year in which the differences are expected to reverse. Deferred tax assets are reduced by a valuation allowance when it is more likely than not that some component or all of the deferred tax assets will not be realized. Tax rate changes are reflected in income during the period such changes are enacted.

Computation of net income per share

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

The computations for basic and diluted net income per share are as follows:

	For the Year Ended December 31, 2005	2004	2003
Numerator:			
Net income	$ 5,800,530	$ 295,563	$ 8,462,141
Denominator:			
Denominator for weighted average common shares outstanding basic	12,378,815	11,632,351	10,189,114
Dilution associated with common stock warrants		5,402	59,389
Dilution associated with the company s stock based compensation plans	904,626	897,917	1,599,765
Denominator:			
Denominator for weighted average common shares outstanding diluted	13,283,441	12,535,670	11,848,268
Net income per share basic	$ 0.47	$ 0.03	$ 0.83
Net income per share diluted	$ 0.44	$ 0.02	$ 0.71

Aggregates of 230,000, 545,000, and 172,000 shares of restricted stock and options to purchase shares of common stock were excluded from the computations of diluted earnings per share for the years ended December 31, 2005, 2004 and 2003, respectively, because they were anti-dilutive.

Comprehensive income

Comprehensive income as defined by SFAS No. 130, Reporting Comprehensive Income, includes net income and items defined as other comprehensive income. SFAS No. 130 requires that items defined as other comprehensive income, such as foreign currency translation adjustments and unrealized gains and losses on certain marketable securities, be separately classified in the financial statements. Such items are reported in the consolidated statements of stockholders equity as comprehensive income.

New accounting pronouncement

In December 2004, the FASB issued SFAS No. 123 (revised 2004), Share-Based Payment. SFAS No. 123R supersedes APB Opinion No. 25, which requires recognition of an expense when goods or services are provided. SFAS No. 123R requires the determination of the fair value of the share-based compensation at the grant date and the recognition of the related expense over the period in which the share-based compensation vests. SFAS No. 123R permits a prospective or two modified versions of retrospective application under which financial statements for prior periods are adjusted on a basis consistent with the pro forma disclosures required for those periods by the original SFAS No. 123. In April 2005, the Securities and Exchange Commission adopted a new rule that amends the compliance dates for SFAS No. 123R. The Company is required to adopt the provisions of SFAS No. 123R effective January 1, 2006, at which time the Company will begin recognizing an expense for unvested share-based compensation that has been issued or will be issued after that date. The Company has determined that it will adopt SFAS No. 123R using the modified prospective application method under which the Company will apply SFAS No. 123R to new awards granted after the adoption of SFAS No. 123R and any portion of existing awards that were granted after December 15, 1994 and have not vested by the date the Company adopts SFAS No. 123R. The Company expects the impact of the adoption of SFAS No. 123R to be material to its consolidated financial statements. The Company estimates that equity-based compensation charges in 2006 will be approximately $4.1 million to $5.0 million after tax, depending on the stock price when new options are granted and the volume and timing of incentive stock option exercises, all of which are difficult to predict. These factors also affect the Company s effective tax rate. Future stock-based compensation will differ from pro forma amounts (see Note 2 schedule labeled Stock-based compensation).

3. Acquisition

The following acquisition was accounted for under the purchase method of accounting under SFAS No. 141, Business Combinations, and accordingly, the assets and liabilities acquired were recorded at their estimated fair values at the effective date of the acquisition, and the results of operations have been included in the consolidated statements of operations since the acquisition date. In accordance with SFAS No. 142, Goodwill and Other Intangible Assets, goodwill recorded as a result of the acquisition is subject to an annual impairment test.

HInnovation, Inc.

On February 18, 2004, the Company completed the acquisition of HInnovation, Inc. (HInnovation) in accordance with the terms and conditions of an Acquisition Agreement and Plan of Reorganization (the Acquisition Agreement) dated as of January 8, 2004. HInnovation is a provider of software solutions that allow physicians to use PCs or notebook computers to access 2D, 3D and 4D medical imaging applications securely over the Internet. The acquisition of HInnovation was made to acquire products and technology that will enable the Company to more effectively compete in the distributed computing market for 2D/3D/4D visualization and analysis software.

The total purchase price of the HInnovation acquisition was approximately $12.6 million. The Company acquired all of the outstanding common stock of HInnovation in exchange for $5.8 million in cash paid and 376,262 newly issued shares of common stock issued to the stockholders of HInnovation. The common stock was valued at $6.1 million for accounting purposes. Vital Images stock was valued at $16.2375 per share, which was equal to the average of the closing sale prices of one share of Vital Images stock as reported on the Nasdaq National Market (now known as the Nasdaq Global Market) for the two consecutive trading days occurring before the first public announcement of the signing of the Acquisition Agreement and the two consecutive trading days occurring immediately after such public announcement date. The Company incurred $360,000 in direct costs of the acquisition and assumed $382,000 of liabilities. The Company did not assume any stock options or warrants.

The Company has a contingent consideration agreement related to the acquisition. The maximum potential contingent consideration was initially $6.0 million. No contingent consideration has been earned, and as of December 31, 2005, the remaining potential maximum contingent consideration was $1.5 million in cash, which may be earned upon porting the Company s base software to HInnovation s Web-based platform and the commercial launch thereof. A second milestone, based upon achieving revenue targets for the HInnovation products by March 2005, was not met and expired. A third milestone, based on licensing products based on patents held by HInnovation by February 2006, was not met and expired. Any contingent payments made by the Company will result in an equivalent increase in goodwill.

The purchase price was allocated to the identified assets of HInnovation. A third-party appraisal firm assisted the Company with the valuation of the identified intangible assets. The valuation resulted in the allocation of $6.9 million to identifiable intangible assets, which will be amortized over periods ranging from three to seven years. The valuation also resulted in the identification of $1.0 million of acquired in-process research and development (IPR&D) costs, which were immediately expensed on the closing date and represent a non-deductible charge for income tax purposes.

At the time of acquisition, HInnovation had development projects in process, including the collaboration module of its Web-based product (the Collaboration Module Project). The Collaboration Module Project involves the design and development of innovative features for Web-based consultation meetings with interactive and synchronized viewing of full-quality images, annotation and mouse movement. The Collaboration Module Project includes significant and innovative advancements to the HInnovation software platform in the areas of network synchronization of high quality images and user privilege management for online collaboration. The design, verification and other processes involved in the Collaboration Module Project require tools and skills that are new to HInnovation. The appraisal referenced above estimated that $1.0 million of the purchase price represents the fair value of purchased IPR&D related to the Collaboration Module Project, that it has not yet reached technological feasibility and that it has no alternative future uses. This amount was expensed as a non-recurring, non-tax-deductible charge upon consummation of the acquisition.

The appraisal firm applied the income valuation approach to assist the Company in determining the estimated fair value of the purchased IPR&D. These estimates were based on the following assumptions:

The estimated revenue was based upon HInnovation s estimate of revenue growth over the next seven years from the revenue growth of primarily the Collaboration Module.

The estimated gross margin of 65% to 78% was based upon gross margin for comparable products.

The estimated selling, general and administrative expenses were based on a consideration of historical operating expenses as a percentage of revenue and HInnovation s projected operating expenses.

The cost to complete each project was based on estimated remaining labor hours and a fully-burdened labor cost and other direct expenses.

The discount rate used in the alternative income valuation approach was based on the weighted average cost of capital (WACC). The WACC calculation produces the average required rate of return of an investment in an operating enterprise based on various required rates of return from investments in various areas of that enterprise. The discount rate used in the alternative valuation approach was 35%. Premiums were added to the WACC to account for the inherent risks in the development of the products, the risks of the products being completed on schedule, and the risk of the eventual sales of the product meeting the expectations of HInnovation.

The first phase of the Collaboration Module was released in the third quarter of 2004. The first phase provided basic collaboration between users, allowing one user to present to another user. The second phase of the Collaboration Module provided two-way collaboration between users, allowing both users to interact with the data, and was released in the third quarter of 2005.

The total purchase price is as follows:

Fair value of common stock issued (376,262 shares)	$	6,109,554
Cash paid to HInnovation shareholders		5,752,626
Direct acquisition costs		360,259
Liabilities assumed		381,562
	$	12,604,001

The allocation of the total purchase price is as follows:

Existing software technology, subject to amortization - 5 year life	$	3,400,000
Patent and patent applications, subject to amortization - 7 year life		3,000,000
Non-compete/employement agreements, subject to amortization - 3 year life		500,000
Goodwill		6,052,744
In-process research and development costs		1,000,000
Deferred tax liabilities, net		(1,405,000)
Fair value of assets acquired		51,468
Fair value of cash acquired		4,789
	$	12,604,001

The following factors contributed to a purchase price that resulted in the recognition of goodwill:

HInnovation had the first Web-based product in the Company s market.

HInnovation had a patent and patent applications that cover certain important aspects of the underlying technology.

HInnovation also had unique technology under development that was included as part of the acquired IPR&D.

The following unaudited pro forma condensed consolidated results of operations have been prepared as if the acquisition of HInnovation had occurred as of the beginning of the periods presented. Pro forma adjustments relate to amortization of identified intangible assets, acquired IPR&D and income taxes. The unaudited pro forma condensed consolidated results of operations are for comparative purposes only and are not necessarily indicative of results that would have occurred had the acquisition occurred as of the beginning of the periods presented, nor are they necessarily indicative of future results.

	For the Year Ended December 31,			
	2004		2003	
Revenue	$	36,150,047	$	27,322,218
Net income	$	1,172,570	$	6,517,277
Net income per share - diluted	$	0.09	$	0.53

4. Financial statement components

Allowance for doubtful accounts

The allowance for doubtful accounts activity was as follows:

	For the Year Ended December 31,					
	2005		2004		2003	
Beginning balance	$	767,000	$	235,000	$	240,000
Provision		43,000		626,800		46,000
Write-offs		(287,185)		(94,800)		(51,000)
Recoveries		(202,395)				
Ending balance	$	320,420	$	767,000	$	235,000

The recovery in 2005 was due to the payment of a receivable for which the Company had previously established a specific allowance.

Property and equipment, net

The components of property and equipment were as follows:

	December 31, 2005	December 31, 2004
Equipment	$ 7,496,476	$ 5,247,471
Furniture and fixtures	2,172,969	1,516,497
Computer software	1,104,836	765,870
Leasehold improvements	1,311,892	273,924
Total property and equipment	12,086,173	7,803,762
Less accumulated depreciation and amortization	(6,724,854)	(4,581,395)
Property and equipment, net	$ 5,361,319	$ 3,222,367

Depreciation expense was $2.1 million, $1.6 million and $1.2 million for the years ended December 31, 2005, 2004 and 2003, respectively.

Licensed technology, net

In July 2001, the Company entered into an agreement to license technology from a third party. The Company paid an aggregate of $750,000 to the licensor in 2001. The Company recorded this $750,000 purchase as licensed technology and is amortizing it over the estimated useful life of the technology of 75 months. This amortization expense is reported as cost of revenue for license fees. As part of this agreement, the Company is also obligated to pay the licensor royalties on the sales of certain products as defined in the agreement. During 2005, 2004 and 2003, $1.4 million, $1.0 million and $772,000, respectively, of such royalties were incurred and were reported as cost of revenue for license fees.

	December 31, 2005	December 31, 2004
Licensed technology	$ 750,000	$ 750,000
Less accumulated amortization	(540,000)	(420,000)
Licensed technology, net	$ 210,000	$ 330,000

Amortization expense was $120,000 for each of the years ended December 31, 2005, 2004 and 2003.

Other intangible assets, net

Acquired intangible assets subject to amortization were as follows:

	December 31, 2005			December 31, 2004		
	Gross Carrying Value	Accumulated Amortization	Net Carrying Value	Gross Carrying Value	Accumulated Amorization	Net Carrying Value
Existing software technology	$ 3,400,000	$ (1,282,000)	$ 2,118,000	$ 3,400,000	$ (598,000)	$ 2,802,000
Patents and patent applications	3,000,000	(810,000)	2,190,000	3,000,000	(378,000)	2,622,000
Non-compete/employment agreements	500,000	(315,000)	185,000	500,000	(147,000)	353,000
Total intangible assets subject to amortization	$ 6,900,000	$ (2,407,000)	$ 4,493,000	$ 6,900,000	$ (1,123,000)	$ 5,777,000

Intangible assets subject to amortization are amortized on a straight-line basis over the estimated period of benefit. Amortization expense was $1.3 million and $1.1 million for the years ended December 31, 2005 and 2004, respectively. The estimated future annual amortization expense for identified intangible assets is as follows:

2006	$ 1,284,000
2007	1,133,000
2008	1,116,000
2009	498,000
2010	432,000

Thereafter		30,000
	$	4,493,000

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

Goodwill

The changes in the carrying amount of goodwill for the year ended December 31, 2005 are as follows:

Beginning balance	$	6,052,744
Goodwill acquired during the year		
Ending balance	$	6,052,744

Deferred revenue

The components of deferred revenue were as follows:

	December 31,			
	2005		2004	
Maintenance and support	$	7,136,577	$	4,734,764
Training		3,528,738		2,697,892
Installation		224,550		309,200
Software		592,353		454,108
Hardware and other		393,590		218,448
Total deferred revenue		11,875,808		8,414,412
Less current portion		(11,230,578)		(8,136,844)
Long-term portion of deferred revenue	$	645,230	$	277,568

5. Commitments and contingencies

Operating lease commitments

The Company rents office space and certain office equipment under operating leases. In addition to minimum lease payments, the office leases require payment of a proportionate share of real estate taxes and building operating expenses. Total rent expense, including an allocation of the lessor s operating costs, was $635,000, $715,000 and $678,000 for the years ended December 31, 2005, 2004 and 2003, respectively.

In March 2004, the Company signed a non-cancelable operating lease for a new office facility in Minnetonka, Minnesota. The new lease term started in February 2005 and expires in January 2012. The Company moved into the Minnetonka location and moved out of its Plymouth, Minnesota location in February 2005. The Company s office facility in Plymouth expired on July 31, 2005 with the exception of a small portion of the space that is under lease until May 31, 2006. Under the terms of the new lease, the Minnetonka lessor will pay the monthly base rent payments and taxes and operating cost rent obligation payments for the Company s former office facility in Plymouth beginning February 2005.

The Company recorded deferred rent of $1.6 million in the first quarter of 2005 relating to estimated payments by the Minnetonka lessor for the benefit of the Company. Such payments are considered lease incentives under FASB Technical Bulletin (FTB) 88-1, Issues Relating to Accounting for Leases, and are amortized as a reduction of rent expense over the term of the Minnetonka lease. The deferred rent balance as of December 31, 2005 was $1.4 million, of which $187,000 was classified as current. Payments by the Minnetonka lessor for the benefit of the Company consist of the following:

$405,000 relating to lease payments to be made by the Minnetonka lessor to the Plymouth lessor; under FTB 88-1, such payments must be recorded as a lease loss by the Company in the first quarter of 2005. Additionally, the Company recorded $88,000 of other costs relating to the Plymouth lease, resulting in a total loss on operating lease of $493,000.

$205,000 relating to moving costs reimbursed to the Company by the Minnetonka lessor; moving costs were expensed as incurred during the first quarter of 2005.

$975,000 relating to leasehold improvements paid for by the Minnetonka lessor; under FTB 88-1, such leasehold improvements must be recorded as an asset by the Company and amortized over the shorter of their estimated useful lives or the remaining terms of the related leases.

The minimum lease payments, excluding estimated taxes and operating cost rent obligations, are approximately:

2006	$	511,000
2007		695,000
2008		728,000
2009		744,000
2010		760,000
Thereafter		841,000
Total	$	4,279,000

Purchase commitments

In April 2005, the Company entered into an agreement with R2 Technology, Inc. (R2) to market R2 s lung nodule CAD software product to the Company s customers. The April 2005 agreement replaced the Company s November 2002 agreement with R2. Under the April 2005 agreement, all previous commitments were cancelled and replaced with a new commitment which began in the third quarter of 2005. The new commitment provides R2 with certain minimum quarterly revenues (Applicable Minimums) from the sale of certain R2 lung CAD related products and services (R2 Lung CAD Products) over a 12-quarter period ending June 30, 2008. The Company will receive a commission based on sales of R2 Lung CAD Products to the Company s customers. This agreement states that to the extent the quarterly Applicable Minimum is not met, the Company will pay R2 the difference between the Applicable Minimum and the actual R2 Lung CAD Product revenue achieved.

The Applicable Minimums for the quarters ending September 30, 2005, December 31, 2005 and March 31, 2006 are $414,000 per quarter. However, beginning in the quarter ending June 30, 2006 and for each subsequent quarter thereafter, the Applicable Minimum will be reduced to the lowest of:

i) the Applicable Minimum in the preceding quarter;

ii) the Applicable Minimum of the preceding quarter multiplied by the percent by which the R2 Lung CAD Product revenue in the preceding quarter fell below that quarter s Applicable Minimum, up to a maximum decline of twenty-three percent (23%); or

iii) two times the R2 Lung CAD Product revenue generated by R2 during the preceding quarter through all other sales, marketing and distribution channels, excluding R2 Lung CAD Product revenue generated from Customers under the agreement.

If at any time during the remainder of the R2 agreement the Applicable Minimum is less than $414,000 and R2 Lung CAD Product revenue for a quarter exceeds $414,000, the Applicable Minimum for the next quarter will be $414,000. Thereafter, the Applicable Minimums will be subject to the above adjustment. Additionally, at the end of every fourth quarter under the April 2005 R2 agreement, if the aggregate revenue generated under the agreement in the previous four quarters exceeded $1,665,000, the remaining Applicable Minimum per quarter shall be reduced by the amount of excess divided by the number of quarters remaining under the agreement.

The Applicable Minimum for the quarter ended December 31, 2005 was not met by approximately $314,000 and, based on current estimates, management believes it is probable that the estimated aggregate Applicable Minimums will not be met for the quarter ending March 31, 2006. Additionally, management estimates that the Applicable Minimum will be $0 after March 31, 2006, as, based on information available to us, R2 has not generated any R2 Lung CAD Product revenue through any other sales, marketing and distribution channels, other than R2 Lung CAD Product revenue generated from Customers under this agreement. Based on these results and future estimates, the Company recorded a $410,000 net loss to sales and marketing expense in the quarter ended December 31, 2005 relating to this agreement to cover estimated losses through March 31, 2006. The $410,000 net loss is based on the fourth quarter of 2005 shortfall of $314,000 and first quarter of 2006 Applicable Minimum of $414,000 offset by the estimated forecasted revenues of $140,000, by the deferred commission fees on sales as of December 31, 2005 of $142,000 and estimated deferred commission fee on forecasted revenues of $36,000. However, the estimated aggregate Applicable Minimums is a subjective determination, and any changes to estimates and actual results could have an adverse impact on the Company s financial position and results of operations. As of December 31, 2005, the remaining potential aggregate Applicable Minimums range from a minimum of approximately $414,000 to a maximum of approximately $4.1 million. Any future losses will be recorded under SFAS No. 5, Accounting for Contingencies, , which requires the amount to be probable and estimable.

The Company has not recognized any commission revenue relating to this agreement, as it was not considered to be fixed or determinable due to the potential for payments by the Company to R2 relating to the Applicable Minimums.

Other items

Under general contract terms, the Company includes an indemnification clause in its software licensing agreement that indemnifies the licensee against liability and damages arising from any claims of patent, copyright, trademark or trade secret infringement by the Company s software. The Company has incurred insignificant costs as a result of this type of indemnification clause, and the Company does not maintain a product warranty liability related to such indemnification clauses.

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

6. Stockholders equity

Background

On October 28, 1996, the Board of Directors of Bio-Vascular, Inc. (Bio-Vascular), now known as Synovis Life Technologies, Inc., the former parent of the Company, approved a plan to spin off and establish the Company as an independent, publicly-owned company. On May 12, 1997 (the Distribution Date), Bio-Vascular distributed all of the shares of the Company to the shareholders of Bio-Vascular (the Distribution), and on that date the Company began operating as an independent public company. All Bio-Vascular shareholders of record as of May 5, 1997 received one share of the Company s common stock for each two shares of Bio-Vascular stock held on that date and cash in lieu of fractional shares.

Private placement

In June 2003, the Company completed a private placement of 1.5 million shares of common stock at $13.50 per share for total gross proceeds of $20.3 million. After deducting offering costs of $1.3 million, the Company received net proceeds of $19.0 million. A registration statement covering the resale of these shares was declared effective on September 29, 2003 by the Securities and Exchange Commission. Effective March 1, 2006, we de-registered the resale of these shares not already sold.

Stock option plans

In May 1997, Bio-Vascular, as the sole shareholder of the Company, approved and adopted the Vital Images, Inc. 1997 Stock Option and Incentive Plan (the Stock Option Plan), which became effective on the Distribution Date. Under the terms of the plan, the Board of Directors may grant options and other stock-based awards to key employees to purchase shares of the Company s common stock at an option exercise price equal to or greater than 85% of the fair market value on the date of grant. The options are exercisable at such times, in installments or otherwise, as the Board of Directors may determine. Generally, these options have a term of eight years and are exercisable as to 28% of the total grant one year after the date of grant and 2% per month thereafter. The total number of shares of common stock that may be issued or awarded under the Stock Option Plan is 4.1 million. As of December 31, 2005, there were 715,181 shares available for the grant of awards under the Stock Option

Plan.

Also in May 1997, Bio-Vascular, as the sole shareholder of the Company, approved and adopted the Vital Images, Inc. 1997 Director Stock Option Plan (the Director Plan) (together with the Stock Option Plan, the 1997 Plans), which became effective on the Distribution Date. The Director Plan provides non-employee directors with automatic grants of stock options and allows the Board of Directors to make additional discretionary option grants to any or all directors. Options that are granted under the Director Plan are granted with an option price equal to the fair market value on the date of grant, with a term of eight years, are non-qualified options and become exercisable in three equal annual installments beginning on the first occurring December 31 after the date of grant. The total number of shares of common stock that may be issued or awarded under the Director Plan is 500,000. As of December 31, 2005, there were 207,000 shares available for the grant of awards under the Director Plan.

The Company had options to purchase 194,000, 199,000 and 205,012 shares outside of the above plans outstanding as of December 31, 2005, 2004 and 2003, respectively. No non-plan options were granted during the years ended December 31, 2005, 2004 or 2003.

Non-employee options

In December 2000, the Company granted options to purchase 10,000 shares to a non-employee consultant. Options to purchase 5,000 shares vest over a four-year period, and the remaining options vested immediately when a specified milestone was achieved, which occurred in May 2003. The options to purchase 5,000 shares that vested in May 2003 were exercised in June 2003. In December 2001, the Company granted options to purchase a total of 4,000 shares to two non-employee consultants and, in December 2002, the Company granted options to purchase an additional 4,000 shares to two non-employee consultants. These options vest over a four-year period. All of the non-plan options have a term of eight years and were granted at exercise prices at least equal to fair market value of the Company s common stock on the date of grant. The Company records compensation expense related to these arrangements based upon the fair values of the options during the periods the consultants provide services. Such fair values are measured using the Black-Scholes option-pricing model. The Company recorded $21,000, $12,000 and $137,000 of compensation expense related to these options for each of the years ended December 31, 2005, 2004 and 2003, respectively.

The following table summarizes stock option activity for 2005, 2004 and 2003:

	Shares Underlying Options		Weighted-Average Exercise Price Per Share
Total outstanding as of December 31, 2002	2,461,844	$	4.98
Options granted	618,750	$	12.04
Options exercised	(574,381)	$	3.55
Options cancelled	(65,241)	$	7.31
Total outstanding as of December 31, 2003	2,440,972	$	7.05
Options granted	514,100	$	12.29
Options exercised	(456,380)	$	4.32
Options cancelled	(172,017)	$	9.80
Total outstanding as of December 31, 2004	2,326,675	$	8.54
Options granted	509,315	$	17.60
Options exercised	(711,288)	$	6.33
Options cancelled	(127,427)	$	11.45
Total outstanding as of December 31, 2005	1,997,275	$	11.45
Options exercisable as of:			
December 31, 2003	1,407,347	$	5.09
December 31, 2004	1,409,650	$	6.74
December 31, 2005	1,185,463	$	9.03

Various price ranges and weighted average information for options outstanding and exercisable as of December 31, 2005 are as follows:

Options Outstanding	Options Exercisable

Range of Exercise Prices			Number Outstanding	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price		Number Exercisable	Weighted Average Exercise Price	
$2.31	-	$7.00	278,779	2.28 years	$	4.62	274,139	$	4.60
$7.25	-	$7.25	350,119	4.19 years	$	7.25	323,914	$	7.25
$7.34	-	$9.60	346,844	4.16 years	$	8.80	271,510	$	8.61
$9.94	-	$12.60	340,983	6.09 years	$	11.93	153,555	$	11.81
$13.01	-	$16.98	385,415	6.95 years	$	16.08	61,900	$	16.66
$17.75	-	$26.75	295,135	7.10 years	$	19.37	100,445	$	19.09
			1,997,275	5.21 years	$	11.45	1,185,463	$	9.03

Employee stock purchase plan

The 1997 Employee Stock Purchase Plan (the ESPP) was approved and adopted by Bio-Vascular, as the sole shareholder of the Company, in May 1997. The ESPP, which became effective on July 1, 1997, enables eligible employees to purchase the Company s common stock at a price equal to 85% of the fair market value of the stock on the date an offering period commences or on the date an offering period terminates, whichever is lower. The ESPP covers an aggregate of up to 250,000 shares of common stock that can be issued and sold to participating employees of the Company through a series of three-month offering periods, beginning July 1, 1997. The ESPP covers substantially all employees, subject to certain limitations. Each employee may elect to have up to 10% of his or her base pay withheld and applied toward the purchase of shares in each such offering period. Purchases under the ESPP for 2005 were 14,526 shares, generating proceeds to the Company of $210,000 at an average purchase price of $14.45; for 2004 were 18,344 shares, generating proceeds to the Company of $172,000 at an average purchase price of $9.37; and for 2003 were 12,995 shares, generating proceeds to the Company of $151,000 at an average purchase price of $11.59. As of December 31, 2005, there were 68,583 shares of common stock reserved for future purchases under the ESPP.

Stock-based compensation

For purposes of calculating the fair value of options under FASB Statement No. 123, the weighted average fair values of options granted were:

	For the Years Ended December 31,		
	2005	2004	2003
Options under the 1997 Plans	$ 10.31	$ 8.30	$ 8.20
Discount on shares under ESPP	$ 4.81	$ 3.47	$ 3.65

The weighted average fair values for the 1997 Plans and the non-plan options were based on the fair values on the dates of grant. The fair values for the 1997 Plans and the non-plan employee options were calculated using the Black-Scholes option-pricing model with the following weighted-average assumptions:

	For the Years Ended December 31,		
	2005	2004	2003
Expected option life	5.0 years	5.0 years	5.0 years
Expected volatility factor	67%	83%	85%
Expected dividend yield	0%	0%	0%
Risk-free interest rate	3.90%	3.41%	3.07%

The fair values for the non-employee options were calculated using the Black-Scholes option-pricing model with the following weighted-average assumptions:

	For the Years Ended December 31,		
	2005	2004	2003
Expected option life	4.38 years	5.38 years	5.9 years
Expected volatility factor	68%	79%	85%
Expected dividend yield	0%	0%	0%
Risk-free interest rate	4.07%	3.50%	2.66%

The weighted-average fair values of shares under the ESPP were based on the 15% purchase discount.

Deferred stock-based compensation

The Company grants nonvested shares of common stock (restricted stock) to certain employees under the Stock Option Plan. The restricted stock vests 25% annually beginning one year after the grant date. The Company records deferred stock-based compensation equal to the fair market value of the common stock on the date of grant and amortizes the deferred stock-based compensation ratably over the vesting term of the grant.

The following table summarizes the activity in deferred stock-based compensation for 2005:

		For the Year Ended December 31, 2005
Beginning balance	$	
Restricted stock awards, net of cancellations		2,020,609
Amortization of deferred stock-based compensation		(313,596)
Ending balance	$	1,707,013

No restricted stock awards were granted in 2004 or 2003.

Warrants

In December 1999, the Company completed a private placement of 1.65 million units at $3.25 per unit. Each unit consisted of one share of the Company s common stock and a redeemable, five-year warrant to purchase an additional share of common stock at $3.75 per share. The warrants were immediately exercisable with an expiration date in December 2004. The warrants could be redeemed by the Company at any time before December 2004 at a redemption price of $.01 per warrant, upon notice of such redemption, provided that (i) the closing bid price of the Company s common stock exceeded $5.75 per share for any 30 consecutive trading days prior to such notice and (ii) a registration statement covering the resale of the warrant shares had been filed by the Company with the Securities and Exchange Commission and was effective as of the date of such notice. The Company satisfied the conditions for redemption of the warrants on December 7, 2000. In December 2001, the Company called for redemption of all outstanding warrants. As of December 31, 2003, all 1.65 million warrants had been exercised.

The Company also issued warrants to the selling agent for the December 1999 private placement to purchase 163,651 shares of the Company s common stock at $3.25 per share. The warrants were immediately exercisable and expired in December 2004. During 2004 and 2003, warrants to purchase 19,156 and 83,063, respectively, were exercised. These warrant exercises generated proceeds to the Company of $18,800 and $248,000 for the years ended December 31, 2004 and 2003, respectively. In conjunction with these exercises, during 2004 and 2003, 3,362 and 1,693 shares, respectively, were forfeited as part of cashless exercises. As of December 31, 2005, none of these warrants remained outstanding.

Rights plan

In April 1997, the Company declared a dividend distribution of one Preferred Stock Purchase Right for each outstanding share of the Company s common stock (the Rights). With certain exceptions, the Rights become exercisable only if one of the following events occurs: (i) an acquiring party accumulates 15% or more of the Company s common stock, (ii) a party announces an offer to acquire 15% or more of the Company s common stock, or (iii) the acquisition of a substantial amount of the Company s common stock by a person whom the Board of Directors has determined is an Adverse Person as defined in the underlying Rights Agreement. Each Right entitles the holder to purchase one-thousandth of a share of the Company s Series A Junior Preferred Stock at a price of $20.00 (the Exercise Price). If a person or group becomes the beneficial owner of 15% or more of the Company s common stock or the Board of Directors determines that a person is an Adverse Person, each holder of a Right shall thereafter have the right to receive preferred stock having a fair market value equal to two times the Exercise Price. Upon the occurrence of certain mergers, combinations or acquisitions of the Company s assets, each holder of a Right shall thereafter have the right to receive that number of shares of common stock of the acquiring company which equals the Exercise Price of the Right divided by one-half of the current market price of such common stock as of the date of the occurrence of the event. The Company is generally entitled to redeem the Right at $.001 per Right at any time until 10 days following the acquisition of 15% or more of the Company s common stock or 10 days after the point at which the Company s Board of Directors determines that a person is an Adverse Person, as defined by the Rights Agreement. The Rights expire on April 30, 2007 if not previously redeemed or exercised.

7. Income taxes

The income tax provision (benefit) for the years ended December 31, 2005, 2004 and 2003 include the following components:

59

	For the Year Ended December 31,		
	2005	2004	2003
Current income taxes:			
Federal	$ 48,000	$ 25,000	$
State	36,000	5,000	79,000
	84,000	30,000	79,000
Deferred income taxes:			
Federal	2,613,000	513,000	(7,657,000)
State	159,000	44,000	1,265,000
Foreign	(25,000)		
	2,747,000	557,000	(6,392,000)
Provision (benefit) for income taxes	$ 2,831,000	$ 587,000	$ (6,313,000)

A reconciliation of the Company s income tax provision (benefit) computed using the federal statutory rate to the tax provision reported in the Company s statements of operations is as follows:

	For the Year Ended December 31,		
	2005	2004	2003
Tax provision computed at the federal statutory rate	$ 2,935,000	$ 300,000	$ 726,000
State taxes, net of federal benefit	299,000	94,000	116,000
Increase (decrease) in tax from:			
Research and development tax credits	(362,000)	(319,000)	(85,000)
Business meals and entertainment	41,000	46,000	34,000
Extraterritorial income exclusion	(27,000)		
Foreign tax rate differential	(5,000)		
Acquired in-process research and development		340,000	
Change in state tax rate	(104,000)	(54,000)	
Change in valuation allowance	47,000	226,000	(7,171,000)
Other, net	7,000	(46,000)	67,000
Provision (benefit) for income taxes	$ 2,831,000	$ 587,000	$ (6,313,000)

The significant components of the Company s tax-effected net deferred tax assets are as follows:

	December 31,	
	2005	2004
Current:		
Accrued expenses and allowances	$ 717,000	$ 600,000
Total current	$ 717,000	$ 600,000
Noncurrent:		
Net operating loss carryforwards	$ 7,760,000	$ 8,880,000
Research and development tax credit carryforwards	2,365,000	1,570,000
Depreciation and amortization	516,000	434,000
Deferred revenue	235,000	105,000
Identified intangible assets	(1,641,000)	(2,193,000)
Other, net	3,000	31,000
Net deferred tax assets before valuation allowance	9,238,000	8,827,000
Less valuation allowance	(289,000)	(373,000)
Total noncurrent	$ 8,949,000	$ 8,454,000

Net operating loss carryforwards and other tax credit carryforwards as of December 31, 2005

The Company had federal tax loss carryforwards of approximately $21.7 million, representing a $7.4 million deferred tax asset as of December 31, 2005. Of the total federal tax loss carryforward, $10.0 million was generated through the exercise of stock options. The federal tax loss carryforwards will expire in 2010 through 2023 if not utilized. The Company estimates that it is more likely than not that this deferred tax asset will be realized prior to expiration.

The Company had state tax loss carryforwards of approximately $6.3 million, representing a $354,000 deferred tax asset as of December 31, 2005. The state tax loss carryforwards will expire at various dates through 2023 if not utilized. The Company recorded a $47,000 valuation allowance related to this deferred tax asset as of December 31, 2005 due to the uncertainty in realization prior to expiration. The Company wrote off $131,000 to the valuation allowance relating to state deferred tax assets for net operating losses no longer available to the Company.

The Company had foreign tax loss carryforwards of approximately $83,000, representing a $25,000 deferred tax asset as of December 31, 2005. The Company estimates that it is more likely than not that this deferred tax asset will be realized prior to expiration.

The Company had other federal and state tax credits and carryforwards of approximately $2.4 million, representing a $2.1 million deferred tax asset as of December 31, 2005. The federal and state credits and carryforwards will expire in 2006 through 2025 if not utilized. The Company had a $242,000 valuation allowance related to this deferred tax asset as of December 31, 2005 due to the uncertainty in realization prior to expiration.

Activity during the year ended December 31, 2005

The Company s methodology for determining the realizability of its deferred tax assets involves estimates of future taxable income from its core business, the estimated impact of future tax deductions from the exercise of stock options outstanding as of December 31, 2005, and the expiration dates and amounts of net operating loss carryforwards and other tax credits. These estimates are projected through the life of the related deferred tax assets based on assumptions which management believes to be reasonable and consistent with current operating results.

Although the Company had cumulative pre-tax income for financial reporting purposes for the three years ended December 31, 2005, the Company did not pay any significant income taxes over that period due to tax deductions from the exercise of stock options as well as its utilization of net operating losses. In assessing the realizability of its deferred tax assets as of December 31, 2005, the Company considered evidence regarding its ability to generate sufficient future taxable income to realize its deferred tax assets. The primary evidence considered included the cumulative pre-tax income for financial reporting purposes for the past three years; the estimated impact of future tax deductions from the exercise of stock options outstanding as of December 31, 2005; and the estimated future taxable income based on historical operating results.

After giving consideration to these factors, the Company concluded that it was more likely than not that tax loss carryforwards will be realized prior to expiration and other tax credits that expire prior to 2010 will not be utilized due to the estimated future tax deductions from the exercise of stock options outstanding as of December 31, 2005 as well as utilization of tax loss carryforwards. As a result, the Company had a valuation allowance of $289,000 as of December 31, 2005 relating to net operating losses and tax credits that expire prior to 2010.

The Company also concluded that it was more likely than not that the net deferred tax assets of $9.7 million as of December 31, 2005 and the estimated future tax deductions from the exercise of stock options outstanding as of December 31, 2005 would be utilized prior to expiring.

Based on this conclusion, the Company would require approximately $55.6 million in cumulative future taxable income to be generated at various times over the next 20 years to realize the related net deferred tax assets of $9.7 million as of December 31, 2005 as well as the estimated future tax deductions from the exercise of stock options outstanding and in-the-money as of December 31, 2005.

If the Company adjusts either its estimates of future taxable income or tax deductions from the exercise of stock options down, or the Company s stock price increases significantly without an increase in taxable income, causing the Company to believe that its deferred tax assets will not be utilized, the Company may need to establish additional valuation allowances on its deferred tax assets, which could materially impact its financial position and results of operations.

Activity during the year ended December 31, 2004

The Company concluded that it was more likely than not that tax loss carryforwards that expire in 2005 and other tax credits that expire within the next four years will not be utilized due to the estimated future tax deductions from the exercise of stock options outstanding as of December 31, 2004. As a result, the Company recorded a valuation allowance of $183,000 for the year ended December 31, 2004. The Company also recorded a valuation allowance of $43,000 relating to 2004 foreign net operating losses that are subject to uncertainty regarding utilization and, therefore, a full valuation allowance was recorded.

Activity during the year ended December 31, 2003

During 2003, the Company concluded that it is more likely than not that substantially all of its net deferred tax assets would be realized, and the Company reversed substantially all of its valuation allowance for net deferred tax assets, which resulted in the recording of a net tax benefit in 2003. The reversal of the deferred tax assets valuation allowance was based upon the Company s historical operating performance and management s expectation that the Company will generate taxable income of at least $25 million in future periods to allow it to realize its deferred tax assets resulting from the tax benefits associated with its net operating loss carryforwards and a significant portion of its research and development tax credit carryforwards, as well as certain other tax benefits related to book and tax income timing differences. The reversal of the valuation allowance resulted in a tax benefit of $7,171,000. This reversal, net of other current year state and federal income taxes, resulted in a net tax benefit of $6,507,000 in 2003.

Net operating loss carryforward limitations

Under Section 382 of the Internal Revenue Code of 1986, certain stock transactions which significantly change ownership, including the sale of stock and the granting of options to purchase stock, could limit the amount of net operating loss carryforwards that may be utilized on an annual basis to offset taxable income in future periods. Future changes in ownership, as defined by Section 382, could result in additional limitations in the amount of net operating loss carryforwards that may be utilized on an annual basis.

8. Employee benefit plan

The Company maintains the Vital Images, Inc. Salary Savings Plan (the Plan), which is intended to qualify under Section 401(k) of the Internal Revenue Code, as amended. The Plan covers substantially all employees. Each employee may elect to contribute to the Plan through payroll deductions up to 25% of his or her salary, subject to certain limitations. At the discretion of the Board of Directors, the Company may make matching contributions equal to a percentage of the salary reduction contributions or other discretionary amounts. The Company paid $103,000 and $44,000 in matching contributions in 2005 and 2004, respectively. There were no contributions to the Plan by the Company in 2003.

9. Major customers and geographic data

Customers accounting for more than 10% of the Company s total revenue are as follows:

	For the Year Ended December 31, 2005	2004	2003
Toshiba Medical Systems Corporation	$ 24,307,000	$ 18,130,000	$ 11,544,000
Percentage of total revenue	47%	50%	42%

The Company s accounts receivable are generally concentrated with a small base of customers. As of December 31, 2005 and 2004, Toshiba accounted for 36% and 23% of the accounts receivable balance, respectively.

All significant long-lived assets of the Company are located in the United States.

Export revenue accounted for 16%, 17% and 13% of total revenue for the years ended December 31, 2005, 2004 and 2003, respectively. Substantially all of the Company s export sales are negotiated, invoiced and paid in U.S. dollars.

Export sales by geographic area are summarized as follows:

	For the Year Ended December 31, 2005	2004	2003
Europe	$ 4,461,000	$ 3,692,000	$ 2,421,000
Asia-Pacific	2,277,000	1,320,000	846,000
Other foreign countries	1,427,000	1,078,000	387,000
	$ 8,165,000	$ 6,090,000	$ 3,654,000

10. Selected quarterly financial data (unaudited)

The following summarized unaudited quarterly financial data has been prepared using the financial statements of Vital Images, Inc.

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
2005				
Total revenue	$ 11,325,000	$ 11,948,000	$ 13,160,000	$ 15,284,000
Gross profit	$ 8,653,000	$ 8,918,000	$ 10,264,000	$ 12,322,000
Net income	$ 1,023,000(1)	$ 734,000	$ 1,621,000	$ 2,421,000
Earnings per share basic (3)	$ 0.08	$ 0.06	$ 0.13	$ 0.19
Earnings per share diluted (3)	$ 0.08	$ 0.06	$ 0.12	$ 0.18
2004				
Total revenue	$ 7,816,000	$ 7,960,000	$ 9,248,000	$ 11,098,000
Gross profit	$ 5,479,000	$ 5,399,000	$ 6,643,000	$ 8,154,000
Net income (loss)	$ (1,352,000)(2)	$ 78,000	$ 670,000	$ 900,000
Earnings (loss) per share basic (3)	$ (0.12)	$ 0.01	$ 0.06	$ 0.08
Earnings (loss) per share diluted (3)	$ (0.12)	$ 0.01	$ 0.05	$ 0.07

(1) Includes a loss on operating lease of $493,000 related to the Company s facility move in the first quarter of 2005.

(2) Includes $1.0 million of acquired in-process research and development charge relating to the acquisition of HInnovation, Inc. in February 2004.

(3) The sum of the quarterly earnings (loss) per share may not equal the annual earnings per share due to changes in average shares outstanding.

Vital Images, Inc.
Form 10-K

Index to Exhibits

Item No.	Description
2.1	Acquisition Agreement and Plan of Reorganization by and among Vital Images, Inc., HInnovation Acquisition, Inc., HInnovation, Inc. and Hui Hu and JMS Co. Ltd. dated as of January 8, 2004, incorporated by reference to Exhibit 2.1 to the Company s Current Report on Form 8-K filed on February 26, 2004.
3.1	Articles of Incorporation of the Company, incorporated by reference to Exhibit 3.1 to the Company s Registration Statement on Form 10 dated March 13, 1997 (Form 10).
3.2	By-laws of the Company, incorporated by reference to Exhibit 3.2 to the Form 10.
4.1	Form of common stock certificate of the Company, incorporated by reference to Exhibit 4.3 to the Form 10.
4.2	Rights Agreement dated effective as of May 1, 1997, between the Company and American Stock Transfer and Trust Company, which includes as Exhibit B the form of Rights Certificate, incorporated by reference to Exhibit 4.4 to the Form 10.
4.3	Certificate of Designation, Preferences and Rights of Series A Junior Preferred Stock of the Company, incorporated by reference to Exhibit 4.5 to the Form 10.
10.1	Employee Stock Purchase Plan, incorporated by reference to Exhibit 10.10 to the Form 10.*
10.2	1997 Stock Option and Incentive Plan, as amended, incorporated by reference to Exhibit 10.11 to the Form 10 and Exhibit 99.9 to the Company s Registration Statement on Form S-8 dated May 23, 2005.*
10.3	1997 Director Stock Option Plan, as amended, incorporated by reference to Exhibit 10.12 to the Form 10 and Exhibit 99.14 to the Company s Registration Statement on Form S-8 dated May 23, 2005.*
10.4	Marketing and Distribution Agreement between Vital Images, Inc. and Toshiba Corporation, Medical Systems Company, incorporated by reference to Exhibit 10.35 to the Company s Quarterly Report on Form 10-Q for the quarter ended March 31, 2002.**
10.5	Amendment No. 1 to Marketing and Distribution Agreement between Vital Images, Inc. and Toshiba Corporation, Medical Systems Company, incorporated herein by reference to Exhibit 10.37 to the Company s Annual Report on Form 10-K for the year ended December 31, 2002.**
10.6	Amendment No. 2 to Marketing and Distribution Agreement between Vital Images, Inc. and Toshiba Medical Systems Corporation, incorporated herein by reference to Exhibit 10.44 to the Company s Annual Report on Form 10-K for the year ended December 31, 2003.**
10.7	Amendment No. 3 to Marketing and Distribution Agreement between Vital Images, Inc. and Toshiba Medical Systems Corporation, incorporated herein by reference to Exhibit 10.1 to the Company s Quarterly Report on Form 10-Q for the quarter ended March 31, 2005.**
10.8	Value Added Reseller Agreement between McKesson Information Systems LLC and Vital Images, Inc. dated June 19, 2003, incorporated herein by reference to Exhibit 10.43 to the Company s Annual Report on Form 10-K for the year ended December 31, 2003.**
10.9	Technology License Agreement between PointDX, Inc. and Vital Images, Inc., incorporated by reference to Exhibit 10.32 to the Company s Quarterly Report on Form 10-Q for the quarter ended September 30, 2001.**

10.10	Amended and Restated Development, Supply, Marketing and Distribution Agreement dated as of June 1, 2003 by and between Vital Images, Inc. and E-Z EM, Inc., incorporated by reference to

Item No.	Description
	Exhibit 10.1 to the Company s Current Report on Form 8-K filed with the Securities and Exchange Commission on August 3, 2004.**
10.11	Product Distribution Agreement between Vital Images, Inc. and R2 Technology, Inc., incorporated by reference to Exhibit 10.38 to the Company s Annual Report on Form 10-K for the year ended December 31, 2002.**
10.12	Employment Agreement dated February 9, 2002 between Vital Images, Inc. and Jay D. Miller, incorporated by reference to Exhibit 10.39 to the Company s Annual Report on Form 10-K for the year ended December 31, 2002.*
10.13	Form of Change in Control Agreement between Vital Images, Inc. and Steven P. Canakes and Jay D. Miller, incorporated by reference to Exhibit 10.40 to the Company s Annual Report on Form 10-K for the year ended December 31, 2000.*
10.14	Employment Agreement dated September 8, 2005 by and between Vital Images, Inc. and Dr. Susan A. Wood, incorporated by reference to Exhibit 99.4 to the Company s Current Report on Form 8-K dated September 12, 2005.*
10.15	Change in Control Agreement dated September 8, 2005 by and between Vital Images, Inc. and Dr. Susan A. Wood, incorporated by reference to Exhibit 99.5 to the Company s Current Report on Form 8-K dated September 12, 2005.*
10.16	Employment Agreement dated September 8, 2005 by and between Vital Images, Inc. and Philip I. Smith, incorporated by reference to Exhibit 99.6 to the Company s Current Report on Form 8-K dated September 12, 2005.*
10.17	Employment Agreement dated September 8, 2005 by and between Vital Images, Inc. and Steven P. Canakes, incorporated by reference to Exhibit 99.7 to the Company s Current Report on Form 8-K dated September 12, 2005.*
10.18	Employment Agreement dated May 16, 2005 by and between Vital Images, Inc. and Michael H. Carrel, incorporated by reference to Exhibit 99.2 to the Company s Current Report on Form 8-K dated May 19, 2005.*
10.19	Change in Control Agreement dated May 16, 2005, by and between Vital Images, Inc. and Michael H. Carrel, incorporated by reference to Exhibit 99.4 to the Company s Current Report on Form 8-K dated May 19, 2005.*
10.20	Agreement dated February 16, 2006 by and between Vital Images, Inc. and Dr. Vincent Argiro, incorporated by reference to Exhibit 99.2 to the Company s Current Report on Form 8-K dated February 16, 2006.*
10.21	Employment Agreement dated October 24, 2005 by and between Vital Images, Inc. and Jeremy A. Abbs, filed herewith.*
10.22	Form of Change in Control Agreement between Vital Images, Inc. and Philip I. Smith and Jeremy A. Abbs, filed herewith.*
10.23	Schedule of Executive Officer Compensation, filed herewith.*
21.1	Subsidiaries of Registrant, filed herewith.
23.1	Consent of PricewaterhouseCoopers LLP, filed herewith.

Item No.	Description
31.1	Certification of Chief Executive Officer Pursuant to Rules 13a-14(a)/15d-14(a) under the Securities Exchange Act of 1934 and Section 302 of the Sarbanes-Oxley Act of 2002, filed herewith.
31.2	Certification of Chief Financial Officer Pursuant to Rules 13a-14(a)/15d-14(a) under the Securities Exchange Act of 1934 and Section 302 of the Sarbanes-Oxley Act of 2002, filed herewith.
32.1	Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, filed herewith.
32.2	Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, filed herewith.

* Indicates a management contract or compensatory plan or arrangement.

** Portions of such exhibit are treated as confidential pursuant to a request for that confidential treatment filed with the Commission by Vital Images.