VITAL IMAGES INC
Form 10-K
March 16, 2010
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2009

OR

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

For the transition period from to

Commission file number: 0-22229

Vital Images, Inc.

(Exact name of registrant as specified in its charter)

Minnesota	**42-1321776**

(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
5850 Opus Parkway, Suite 300 Minnetonka, MN 55343-4414 (Address of principal executive offices)	**55343-4414** (Zip Code)

(952) 487-9500

(Registrant s telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	**Name of Each Exchange on Which Registered**
Common Stock, $.01 par value	NASDAQ Global Select Market

Securities registered pursuant to Section 12(g) of the Act: **None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes o No x

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes o No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

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

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

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

As of June 30, 2009, the last day of the registrant s most recently completed second fiscal quarter, the aggregate market value of the registrant s common stock held by non-affiliates of the registrant was $161,839,241. The common stock is the registrant s only class of voting stock.

The number of shares outstanding of the issuer s class of common stock as of March 9, 2010 was 14,425,889 shares.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of registrant s definitive Proxy Statement in connection with the Annual Meeting of Stockholders to be held May 11, 2010 (2010 Proxy Statement) are incorporated by reference into Part III of this Form 10-K, as indicated in Items 10 through 14 of Part III.

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Part I

Cautionary Statement Regarding Forward-Looking Information

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

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

Item 1. Business

Our Business

Vital Images, Inc. (Vital Images, we, us, or our) is a leading provider of advanced visualization and image analysis solutions for use by medical professionals in clinical analysis and therapy planning for medical conditions. We provide software, customer education, software maintenance and support, professional services and, on occasion, third-party hardware to our customers. Our technology rapidly transforms complex data generated by diagnostic imaging equipment into functional digital images that can be manipulated and analyzed using our specialized applications to better understand internal anatomy and pathology. Our solutions are designed to improve physician workflow and productivity, enhance the ability to make clinical decisions, facilitate less invasive patient care, and complement often significant capital investments in

diagnostic imaging equipment made by our customers. Our software is compatible with equipment from all major manufacturers of diagnostic imaging equipment, such as computed tomography (CT) scanners, and can be integrated into picture archive and communication systems (PACS). Many hospitals use PACS to acquire, distribute and archive medical images and diagnostic reports, reducing the need for film and increasing reliance on advanced visualization solutions such as ours. We also offer a Web-based solution that provides physicians with anywhere, anytime access to medical images and visualization tools through any Internet-enabled computer.

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We were founded and incorporated in Iowa in September 1988, and we re-incorporated in Minnesota in March 1997. Our principal executive offices are located at 5850 Opus Parkway, Suite 300, Minnetonka, MN 55343 (telephone (952) 487-9500, facsimile (952) 487-9510, e-mail info@vitalimages.com). From May 24, 1994 through May 11, 1997, we were a wholly-owned subsidiary of Bio-Vascular, Inc., which is now known as Synovis Life Technologies, Inc.

Our corporate website address is www.vitalimages.com. To access our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, other reports and documents filed with or furnished to the United States Securities and Exchange Commission (the SEC) and amendments to these reports free of charge, go to the Investors section of our website, then to the Financial Information category, and then to the SEC Filings subcategory, where we make such filings available as soon as reasonably practicable after they are filed with or furnished to the SEC. The Corporate Governance category of the Investors section of our website also contains free copies of the Charters for the Audit Committee, Compensation Committee, and Governance Committee of our Board of Directors, as well as our Code of Business Conduct and Ethics, which is our written code of ethics under Section 406 of the Sarbanes-Oxley Act of 2002. Each of the above referenced documents can also be obtained free of charge (other than a reasonable charge for copying exhibits to our reports on Forms 10-K, 10-Q or 8-K) in print by any shareowner who requests them from our investor relations department. The investor relations department s email address is investorrelations@vitalimages.com and its mail address is: Investor Relations, Vital Images, Inc., 5850 Opus Parkway, Suite 300, Minnetonka, MN 55343. Information available on our website is not incorporated by reference into this Annual Report on Form 10-K.

You may also obtain copies of our SEC filings on the SEC s website at www.sec.gov or at the SEC s Public Reference Room at 100 F Street N.E., Washington, D.C. 20549. You may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330.

Products and Services

Our software solutions are used with medical diagnostic equipment, primarily in clinical analysis and therapy planning. Our software applies proprietary technologies to a variety of data supplied by CT scanners to allow medical 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. Our main customers are hospitals and clinics, university medical schools and diagnostic imaging centers. We market our products and services to these customers both directly through our own sales force and indirectly through digital imaging equipment manufacturers and PACS companies, who sell our products with other products they either manufacture or acquire from third parties.

Our products initially were used by radiologists on dedicated workstations to interpret data generated by scanning equipment. Our main product for this type of use was and remains *Vitrea®.* Over time, other medical specialists, primarily cardiologists, began to use advanced visualization software on dedicated workstations. As additional types of specialists began desiring access to the benefits provided by advanced visualization tools, we began to integrate our products onto workstations connected to PACS and to offer a server-based advanced visualization solution called *ViTALConnect®.*

In 2008, we further expanded access to our advanced visualization products throughout the entirety of the hospital enterprise with our introduction, at that time, of *Vital Enterprise*. Our enterprise offerings expand the relevance of our advanced visualization options products beyond the radiology department to referring physicians and surgical specialists, particularly in the areas of cardiology, cardiovascular, oncology, neurology and gastroenterology. Our current enterprise offering is called *Vitrea Enterprise Suite,* which combines all of our proprietary advanced visualization tools into one offering, and may include our proprietary back-end data management software, *Vital Image Management System*. *Vitrea Enterprise Suite* can be used by every medical professional that practices with our customer s enterprise. Both our enterprise and workstation products also serve as an integration platform for applications offered by our visualization technology partners.

Our products work with equipment from all major manufacturers of diagnostic imaging systems, including Toshiba Medical Systems Corporation (Toshiba), GE Healthcare (GE), Siemens Medical Systems, Inc. (Siemens) and Philips Medical Systems (Philips). Our products may also be integrated into PACS, such as those marketed by

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McKesson Corporation (McKesson) and Sectra AB (Sectra), and run on off-the-shelf third-party computer hardware.

In addition to software products and installation services, we provide maintenance and support services, as well as certain other services, such as professional consulting services and customer education. We offer maintenance and support services for our software solutions pursuant to which we provide error correction, software enhancements, updates and upgrades, telephone support and other general support services. We provide customer education services for our customers, both in connection with their acquisition of our software and as independent purchases. We conduct customer education programs for our software at our headquarters in Minnetonka, Minnesota, at customers locations and at various designated locations through the United States.

We have also signed reseller distribution agreements that allow us to distribute products from certain third parties. These third-party products include MeVis Medical Solutions Inc. s ImageChecker® CT software applications for the detection of lung nodules; Mirada Solutions Ltd. s Fusion 7D software application for the anatomical alignment of two different image data sets from two different types of diagnostic equipment, such as combining images from CT and PET scanners; Merge Healthcare Incorporated s CADstream breast MRI software; and Medis Inc. s QMass® MR software.

Marketing and Distribution

We market our products both as standalone software packages and as part of integrated software and hardware systems to radiologists, surgeons, primary care physicians and medical researchers. We market our products directly to end-user customers and through business partners, including diagnostic imaging equipment manufacturers, PACS companies, and software developers, all of whom sell our products with products they either manufacture or acquire from third parties.

Our marketing partners include Toshiba, which markets our software to its customers through its subsidiaries and distributors worldwide. Our agreement with Toshiba commenced in 2001, and it has been extended multiple times, most recently through December 31, 2013. The Marketing and Distribution Agreement, which was entered into by Toshiba and us on November 21, 2008, is a typical reseller or distributor agreement, under which Toshiba resells our imaging products in connection with its sales of its own scanner equipment. Under the Marketing and Distribution Agreement, Toshiba markets and resells our products to its customers. Our sales team may provide assistance to Toshiba in its sales efforts, in a similar manner to how our sales team provides assistance to our other resellers, and we provide back-up technical support for problems that Toshiba cannot resolve. The Marketing and Distribution Agreement ensures a minimum amount of purchases from us by Toshiba. Because purchases by Toshiba have exceeded their commitments, these minimum purchase obligations have not been triggered to date, nor do we have reason to expect these provisions to be triggered in the future. Sales through Toshiba are a material portion of our revenues, comprising approximately 54% of our 2009 revenues, 52% of our 2008 revenues and 47% of our 2007 revenues.

We also have marketing and reseller agreements with several other companies, such as McKesson, Sectra and Cerner Corp., under which these companies may resell our products to their customers as add-on components to their products.

Geographic Information

Our export sales and long-lived assets by significant geographic areas are presented in Note 10 of the Consolidated Financial Statements in our 2009 Annual Report on Form 10-K, listed in Item 15(a)(1) of the Form 10-K.

Research and Development

Our research and development activities are focused on the development of new products and on improvements to existing products. Research and development expense was $16.3 million, $20.3 million and $18.5 million for the years ended December 31, 2009, 2008 and 2007, respectively.

In addition to our Marketing and Distribution Agreement with Toshiba, noted above, we also have entered into a Technology Development Agreement, which became effective on January 8, 2009 and calls for development of

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software or clinical applications by us under Product Development Plans, as such term is defined in the Technology Development Agreement. Each Product Development Plan is separately entered into between Toshiba and us and discusses the key features of the project, including the product to be developed, development milestones, and the amount and timing of funding to be provided by Toshiba for the development effort. Upon completion of the project, we can sell the product that is developed both through Toshiba and, after a 180-day exclusivity period, through our direct sales force, although the exclusivity period may be waived for certain projects. We dedicate a specific number of our personnel exclusively to each project that is funded by Toshiba. The Technology Development Agreement currently will terminate six months following the end of all active Product Development Plans, although it may renew upon written agreement by Toshiba and us. If at any time no projects are ongoing during the term of the Technology Development Agreement, Toshiba will continue to provide funding to us at the rates set forth in the Agreement for up to six months for any of our personnel who are assigned to and actively engaged on projects related to errors reported in any project software that was previously released. In addition, Toshiba will also continue to provide funding for the dedicated project personnel for up to six months during the term, if no project is ongoing, or for up to six months after the term, to assist us to cover reallocation and/or termination costs. Funding received by us under the Technology Development Agreement is accounted for as an offset to research and development expense. We recognized a credit to research and development expenses of $1.1 million under the Technology Development Agreement in 2009.

Competition

The advanced visualization market is highly competitive, subject to rapid change and is significantly affected by new product introductions and other market activities of industry participants. Our products compete based on a multitude of factors, including quality, performance, functionality, clinical features, quality of support and service, reputation, brand and price. Our primary competitors are diagnostic imaging system suppliers, which are typically large, multinational companies with far greater financial and technical resources. They also have well-established sales and distribution networks for their products. These companies, including GE, Siemens, and Philips, develop and market medical imaging systems, such as CT and MR equipment, which may be purchased with integrated medical imaging capabilities. Our software works on the products offered by each of these companies. To win business against equipment manufacturers, we must convince customers to buy our solution separately from their purchase of imaging equipment instead of buying integrated systems from our competitors or we must persuade them that introducing our enterprise product throughout their hospitals will provide them with unique benefits not provided by our competitors.

We also face competition from PACS vendors and other suppliers of medical imaging systems and software. PACS companies sometimes provide medical imaging capability in addition to their image archiving and networking products. Some of the diagnostic equipment manufacturers, including GE and Philips, also offer PACS that comprise a large share of the PACS market. Vendors of hospital, clinical and radiology information systems have also diversified into the PACS and medical imaging product lines, either through internal development or business development and partnership channels. These companies, which may be large or small, attempt to offer an integrated system covering a full range of administrative, clinical and radiology information management capabilities to healthcare providers. Other suppliers of medical imaging systems and software, such as TeraRecon, Inc., compete on the basis of volume rendering or other visualization technologies, specific applications or market niches. We are seeing additional competitors enter our market, but have yet to see these competitors attain a meaningful share of the market.

Intellectual Property

We rely primarily on a combination of trade secret and copyright law, employee and third-party nondisclosure agreements and other protective measures to protect intellectual property rights pertaining to our products and technologies. We do not own all of the software and other technologies used in our products, but we believe we have the necessary licenses from third parties to use that technology in our current products. It may be necessary to renegotiate with such third parties for any new versions of current products or any new products. Such

third-party licenses may not be available on reasonable terms, or at all.

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Governmental Regulation

As medical devices, our software solutions are subject to extensive and rigorous regulation by numerous governmental authorities, principally the U.S. Food and Drug Administration (FDA) and corresponding foreign agencies. In the United States, the FDA administers the Federal Food, Drug, and Cosmetic Act, its amendments (the FD&C Act) and its related regulations. The FD&C Act and these regulations classify medical devices as Class I, II or III devices, which are subject to general controls, special controls or pre-market approval requirements, respectively. Most Class I and II devices, as well as some Class III devices, can be cleared for marketing pursuant to a 510(k) pre-market notification. The process of obtaining a 510(k) clearance typically can take several months to a year or longer.

Class III devices generally require more stringent clinical investigation and pre-market clearance requirements. In such cases, the FDA will require that the manufacturer submit a pre-market approval (PMA) application that must be reviewed and approved by the FDA prior to the sale and marketing of the device in the United States. The process of obtaining a PMA can be expensive, uncertain and lengthy, frequently requiring anywhere from one to several years from the date of FDA submission, if approval is obtained at all. Moreover, a PMA, if granted, may include significant limitations on the indicated uses for which a product may be marketed.

Our software is classified as a Class II medical device and has received marketing clearances from the FDA as the result of 510(k) pre-market notifications. Specifically, our software in general release has been cleared to be marketed for use with CT, MR and PET scanners. Future products, add-on options to existing software, and expanded claims of efficacy will likely require additional 510(k) pre-market notifications.

There can be no assurance that future FDA review processes will not involve delays or that clearances will be granted on a timely basis. In recent years, the FDA has increased its level of scrutiny of medical devices involving software, which requires us to produce additional documentation about the safety and effectiveness of our devices in order to obtain regulatory clearance, and which can lengthen the time required to obtain such clearance. Further, if any of our current or future products become classified as Class III devices, they could be subject to an even more expensive, uncertain and lengthy approval process, and approval, if granted, could include significant limitations on the indicated uses for which a product may be marketed.

We are also subject to regulation in foreign countries in which we sell our products. Many of the regulations applicable to our products in such countries are similar to those of the FDA, but the regulations in several countries, particularly in Asia, may be more particular than those of the FDA, and significantly greater time and resources may be required to obtain approval in those countries. Our ability to successfully market and sell our products in foreign markets depends in large part on our ability to comply with such foreign regulatory requirements. Our products have been Conformité Europeene (CE) marked, indicating conformance with applicable sections of the Medical Device Directive 93/42/EEC, as amended by 2007/47/EC, which allows the products to be marketed in the member countries of the European Communities.

We are also subject to periodic inspections by the FDA and similar foreign regulatory agencies, whose primary purpose is to audit our compliance with quality system regulations established by the FDA and other applicable government standards. Regulatory action may be initiated in response to audit deficiencies or product performance problems. We believe that our manufacturing and quality control procedures comply with all applicable requirements of the FDA and foreign regulatory agencies in countries in which we sell our products. We have received and maintain ISO 13485: 2007 Certification.

Medicare and Medicaid laws and regulations may impact the financial arrangements through which we market, sell and distribute our products and services to patients who are Medicare or Medicaid beneficiaries. Violations of these laws and regulations may result in civil and criminal penalties, including substantial fines and imprisonment. In a number of states, the scope of these laws and regulations has been extended to include the provision of services or products to all patients, regardless of the source of payment, although there is variation from state to state as to the exact provisions of such laws or regulations. In other states, and on a national level, several health care reform initiatives have been proposed which would have a similar impact. We believe that our operations and our marketing, sales and distribution practices currently comply with all current applicable fraud and abuse and physician anti-referral laws and regulations.

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Employees

As of December 31, 2009, we had 246 full-time employees, with 87 involved in research and development, 70 in sales and marketing, 51 in technical support functions and 38 in administrative functions. We believe our relationship with our employees is good.

Item 1A. Risk Factors

The discussion of our business and operations included in this annual report on Form 10-K should be read together with the risk factors set forth below. They describe various risks and uncertainties to which we are or may become subject. These risks and uncertainties, together with other factors described elsewhere in this report, have the potential to affect our business, financial condition, results of operations, cash flows, strategies or prospects in a material and adverse manner. New risks may emerge at any time, and we cannot predict those risks or estimate the extent to which they may affect financial performance. Each of the risks described below could adversely impact the value of our securities. These statements, like all statements in this report, speak only as of the date of this report (unless another date is indicated), and we undertake no obligation to update or revise the statements in light of future developments.

We offer only one line of products, which is advanced visualization software, related services and hardware, and if our products do not continue to gain market acceptance, our financial results would be adversely affected.

Our current market success depends on our ability to successfully market advanced visualization software for clinical use, and on the ability and willingness of physicians to use enterprise-wide advanced visualization medical imaging software in clinical analysis and therapy planning. Our enterprise-wide advanced visualization software products are alternatives to the conventional methods traditionally used for viewing medical images in the clinical setting. Often, a purchase by a customer of our products means that it has chosen not to utilize software that was provided in connection with the customer s purchase of a scanner, which means that the customer may pay additional amounts to obtain our products. The acceptance of our products by physicians and other clinicians will depend on our ability to educate those users as to the speed, ease-of-use and other benefits offered by our products and systems, as well as our timely introduction of new features and functions. There can be no assurance that users will prefer advanced visualization and analysis software solutions over less expensive 2D medical imaging software or that we will succeed in our efforts to further develop, commercialize and achieve market acceptance for our products or for any other product in the clinical setting. If our single line of products does not continue to gain market acceptance, our financial results will be adversely affected.

A substantial portion of our revenue is derived from sales of our software in connection with customer purchases of computer tomography, or CT, scanners, and any decline in the purchase of CT scanners or any difficulty we have in growing sales separately from sales of CT scanners could have a material adverse effect on our results of operations and financial condition.

Our business historically was tied to sales of our advanced visualization products on a workstation basis, which were typically purchased concurrently with a customer s purchase of CT imaging equipment. The market for CT imaging equipment was down significantly in 2009 and is not expected to recover to its past levels within the foreseeable future. In order to improve the marketability of our products separately from sales of CT imaging equipment, during 2008, we evolved our products and business model into sales throughout a customer s enterprise. We have sold our enterprise-wide advanced visualization products through our direct sales channel since then and began to grow sales of it through our reseller channel during 2009. However, there can be no assurance that sales of our enterprise-wide advanced visualization product through

our reseller channel will not remain dependent upon the CT sales cycle, or that such products will be sold by our resellers at the same level as they previously sold our advanced visualization products on a workstation.

We presently depend on Toshiba for a significant portion of our total revenues. A reduction in the business from Toshiba could adversely affect our revenues and could seriously harm our business.

One of our principal distribution channels is to sell our medical imaging software in connection with medical imaging equipment sold by Toshiba. Sales to Toshiba accounted for 54% of our total revenue for the year ended December 31, 2009, 52% of our total revenue for the year ended December 31, 2008 and 47% of our total revenue

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for the year ended December 31, 2007. Toshiba s accounts receivable represented 36% of our accounts receivable at December 31, 2009 and 42% at December 31, 2008. Except for our agreement with Toshiba, we have no significant purchase commitments from any of our customers or business partners, and we generally make sales pursuant to individual transactions. Our joint distribution agreement with Toshiba commenced in 2001 and has been extended multiple times, most recently through December 31, 2013. However, Toshiba does have the ability to conduct in-house development of advanced visualization capabilities for all Toshiba modalities which could lead to a reduction in Toshiba s need for our products in the future. A reduction, delay, or cancellation of orders from Toshiba, or our inability to collect accounts receivable from Toshiba, likely would have a material adverse effect on our financial condition and operating results.

We operate in a single industry and are therefore dependent upon payer reimbursement rates and market demand for advanced visualization products and services. If reimbursement rates decline or if our market does not grow as we expect, our business, results of operations and financial condition will be adversely affected.

State and federal governmental agencies and private payers are putting pressure on reimbursement rates for advanced visualization examinations, which can negatively affect demand for our products. Many of the major hospitals and medical research centers within the United States have already purchased scanners, PACS and advanced visualization technologies, causing future sales to be upgrades or replacements instead of new installations, potentially lengthening the sales cycles as customers feel less urgency to purchase and implement new systems.

Given the uncertainties associated with the developing stage of many of the geographic and medical specialty markets that we believe represent growth opportunities, there can be no assurance that they will develop in the manner we anticipate or that they will not require a level of investment greater than we expect. Additionally, some of our customers finance their acquisitions through third-party lenders. With the unpredictability of credit availability in the lending market, some customers who would otherwise purchase our products may not be able to obtain sufficient financing and therefore will not complete their purchases. Accordingly, there can be no assurance that the advanced visualization industry will provide growth opportunities for us and our software products or that our business strategies will be successful as the industry continues to evolve. Ultimately, if the advanced visualization industry fails to develop as we expect, our business, results of operations and financial condition will be materially and adversely affected.

Most of our products are used with CT scanning equipment, and are therefore dependent upon the amount of use of CT equipment. If usage of CT equipment is reduced, our business, results of operations and financial condition will be adversely affected.

Most of our products are used with CT scanning equipment, which uses ionizing radiation to generate images of the body. Recently, media and regulatory concern has been directed at the dosage of radiation that may be given to a patient undergoing a CT scan. The optimal radiation dose is no more or less than what is necessary to produce a high-quality image, according to a recent FDA white paper. If the current concern results in a reduction in market demand for CT scans, it is likely that the demand for our products could also be reduced. Unless we are successful in developing significant usage for our products other than in connection with CT image data, if the CT equipment manufacturers are unable to develop scanners that produce meaningful data at lower doses of radiation or we are unable to develop software that provides useful images based on the lower dosage levels, our financial results could be adversely affected. Further, recent healthcare regulatory reform seeks to increase the percentage of time of utilization for each scanner that is used in the United States. Utilization reform, while increasing usage of existing scanners, could reduce demand for future scanner purchases, and reduced demand for scanner purchases could materially and adversely affect our business, results of operations and financial condition.

We participate in a highly competitive industry. If we fail to compete effectively, our results of operations and financial condition would be adversely affected.

We face intense competition in the advanced visualization industry. We expect technology to continue to develop rapidly, and our success will depend to a large extent on our ability to maintain a competitive position with our products. Our competitors in the advanced visualization industry include large, established manufacturers of CT and MR imaging equipment. Companies such as GE, Siemens and Philips typically offer their own advanced visualization software and workstations as part of their integrated imaging and scanner systems. Our software works

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on the products offered by each of these companies. To win business against equipment manufacturers, we must convince customers to buy our software solutions separately from their purchase of imaging equipment instead of buying integrated systems from our competitors.

In addition to having a competitive advantage in marketing advanced visualization tools as an integrated part of their imaging products, many of our competitors have significantly greater capital and staffing resources for research and development, more recognizable brand names, and more well-established marketing and distribution networks. Although price has been less significant than other factors, increasing competition may result in price reductions and reduced gross margins. Additionally, we face competition from other entities, such as PACS vendors and developers of competitive or ancillary software packages. The advanced visualization market is characterized by rapid innovation and technological change. For example, as scanners become faster and generate increasingly more slices, our software must maintain its capability to handle the increased data volumes generated by such scanners. We may devote time and resources to develop products that do not obtain market acceptance or for which the market is much smaller than we expected when we planned the products. Products developed by our competitors may render our products obsolete or non-competitive. Similarly, our competitors may succeed in developing or marketing products that are viewed as providing superior clinical performance, enterprise access and performance, or are less expensive than our current or future products.

As a result, we may not be able to compete effectively with such manufacturers or competing entities on each or any particular factor, including price, features and service.

As our products are accessed by additional medical professionals throughout an enterprise, the satisfaction of our customers may decrease.

Historically, our products were used by radiologists who received education on the use of imaging products in medical school and continuing education programs and to whom we provided training in connection with their purchases. For radiologists, use of medical imaging products is a relatively routine activity. As our products are used by additional medical professionals throughout an enterprise, they will be used by persons with less training and familiarity with imaging technologies. Occasional and less-trained users of imaging technology may find use of our products to be more difficult than do radiologists, which could increase our time and expenses supporting these users, thus negatively affecting our gross margins for support services. Further, these users may realize less satisfaction than do our historical customers, negatively affecting the adoption of our products elsewhere in the enterprise. Finally, occasional and less-trained users are more likely to use our products incorrectly. Although our products are intended to be secondary analytical devices, their incorrect use could result in errors by medical professionals in their treatment of patients, lowering their satisfaction with our products and potentially exposing us to legal and regulatory liability, which could affect our results of operations and ability to market our products.

We may make future acquisitions, which may be difficult to integrate, divert management resources, result in unanticipated costs or dilute our shareholders.

Part of our continuing business strategy is to evaluate possible acquisitions of, or investments in, companies, products or technologies that complement our current products, enhance our market coverage or technical capabilities, or offer growth opportunities. Future acquisitions could pose numerous risks to our operations, including:

- we may have difficulty integrating the purchased operations, technologies or products;

- we may incur substantial unanticipated integration costs;

- assimilating the acquired businesses may divert significant management attention and financial resources from our other operations and could disrupt our ongoing business;

- acquisitions could result in the loss of key employees, particularly those of the acquired operations;

- we may have difficulty retaining or developing the acquired businesses customers;

- acquisitions could adversely affect our existing business relationships with suppliers and customers;

- we may fail to realize the potential cost savings or other financial benefits and/or the strategic benefits of the acquisitions; and

- we may incur liabilities from the acquired businesses for infringement of intellectual property rights or other claims, and we may not be successful in seeking indemnification for such liabilities or claims.

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Further, we may not receive the returns from an acquisition that were expected at the time of acquisition. In connection with any acquisition or investment, we could incur debt, be required to amortize expenses related to intangible assets, incur large and immediate write-offs, experience volatility in future earnings resulting from contingent consideration, assume liabilities, or issue stock that would dilute our current shareholders percentage of ownership. We may not be able to complete acquisitions or integrate the operations, products or personnel gained through any such acquisition without a material adverse effect on our business, financial condition and results of operations.

We sell our products internationally and are subject to various risks relating to such international activities, which could harm our international sales and profitability.

During the years ended December 31, 2009, 2008 and 2007, 34%, 29% and 19% of our total revenues, respectively, were attributable to international sales. Toshiba has been the primary source of our international sales. We are also developing direct international sales and marketing efforts. By doing business in international markets, we are exposed to risks separate and distinct from those we face in our domestic operations. Our international business may be adversely affected by changing economic conditions in foreign countries. Because most of our sales are currently denominated in U.S. dollars, if the value of the U.S. dollar increases relative to foreign currencies, our products could become more costly to the international consumer and therefore less competitive in international markets, which could adversely affect our profitability. Furthermore, the percentage of sales denominated in non-U.S. currencies may increase in the future, in which case fluctuations in exchange rates could affect demand for our products.

Most of our business in markets outside the United States is provided through third parties with whom we have marketing agreements. There can be no assurance that these third parties will wish to continue our relationships on an indefinite basis or under the same terms as the business is currently conducted. Further, although we have developed direct relationships with customers in markets outside the United States, we may not be successful in doing so at a sufficient level. The loss of or adverse changes in our relationships with our third-party business partners, and our failure to establish sufficient direct relationships with customers outside the United States, would have a material adverse impact on our business, financial condition and results of operations.

Engaging in international business inherently involves a number of other difficulties and risks, including:

- export restrictions and controls relating to technology;
- the availability and level of reimbursement within prevailing foreign healthcare payment systems;
- pricing pressure that we may experience internationally;
- required compliance with existing and new foreign regulatory requirements and laws;
- business customs in other countries that violate U.S. laws, such as the Foreign Corrupt Practices Act;
- laws and business practices favoring local companies;
- longer payment cycles;

- difficulties in enforcing agreements and collecting receivables through foreign legal systems;
- political and economic instability;
- potentially adverse tax consequences, tariffs and other trade barriers;
- international terrorism and anti-American sentiment;
- difficulties and costs of staffing and managing foreign operations;
- changes in currency exchange rates; and
- difficulties in enforcing intellectual property rights.

Our exposure to each of these risks may lower our revenues, increase our costs, lengthen our sales cycle and require significant management attention. We cannot assure you that one or more of these factors will not harm our business.

If our internal control over financial reporting is found to be inadequate, our financial results may not be accurate, raising concerns for investors and potentially adversely affecting our stock price.

Under Section 404 of the Sarbanes-Oxley Act of 2002, we are required to evaluate and determine the effectiveness of our internal controls over financial reporting. We have dedicated a significant amount of time and resources to

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ensure compliance with this legislation in recent years and will continue to do so for future periods. We may encounter problems or delays in completing the evaluation, the implementation of improvements, and the receipt of a positive attestation, or any attestation at all, from our independent registered public accounting firm. In addition, our assessment of our internal controls may identify deficiencies that need to be addressed in our internal controls over financial reporting or other matters that may raise concerns for investors as to the accuracy of our reported financial results and adversely affect our stock price.

We may experience fluctuations in operating results, which may result in volatility in the price of our common stock.

We have in the past experienced, and may in the future experience, significant fluctuations in annual and quarterly operating results. If these fluctuations occur, they may result in volatility in the price of our common stock. Quarterly revenue and operating results may fluctuate as a result of a variety of factors that are outside of our control including, but not limited to, the timing of significant orders, the timing of product enhancements and new product introductions by us or our competitors, the pricing of our products, changes in customers budgets and competitive conditions. Our quarterly license and services revenue may fluctuate and may be difficult to forecast for a variety of reasons, including the following:

- a significant number of our existing and prospective clients decisions regarding whether to enter into license agreements with us are made within the last few weeks or days of each quarter;
- the size and number of license transactions can vary significantly;
- our dependence on Toshiba or any other major customer for a significant portion of our revenues;
- a decrease in license fee revenue which may likely result in a decrease in services revenue in the same or subsequent quarters;
- clients unexpectedly postponing or cancelling projects due to changes in their strategic priorities, project objectives, budget or personnel;
- the uncertainty caused by potential business combinations in the software industry, causing clients and prospective clients to cancel, postpone or reduce capital spending projects on software;
- client evaluations and purchasing processes that vary significantly from company to company, and a client s internal approval and expenditure authorization process that is difficult and time consuming to complete, even after selection of a vendor;
- the number, timing and significance of software product enhancements and new software product announcements by us or our competitors;
- existing clients declining to renew support for our products, and market pressures that limit our ability to increase support fees or require clients to upgrade from older versions of our products; or
- prospective clients declining or deferring the purchase of new products or releases if we do not have sufficient client references for those products.

We are subject to government regulation of our products, which can result in additional costs or restrict our ability to market our products.

Our products are subject to regulation by the FDA and by comparable agencies in foreign countries. In the United States, the FDA regulates the development, introduction, manufacturing, labeling and record keeping procedures for medical devices, including medical imaging software and systems. Our medical devices require clearance or approval by the FDA before they can be commercially distributed in the United States. Modifications and enhancements to a medical device also require a new FDA clearance or approval if they could significantly affect its safety or effectiveness or would constitute a major change in its intended use, design or manufacture. The FDA requires every manufacturer to make this determination in the first instance, but the FDA may review any manufacturer s decision and may require a new clearance or approval for the modification if it disagrees with the manufacturer s decision. If the FDA requires us to seek clearance or approval for the modification of a previously cleared product for which we have concluded that new clearances or approvals are unnecessary, we may be required to cease marketing or to recall the modified product until we obtain clearance or approval, and we may be subject to significant regulatory fines or penalties, which could have a material adverse effect on our financial results and competitive position. The process of obtaining marketing clearance from the FDA for new products and new applications for existing products can be time-consuming and expensive. All of our current products are marketed pursuant to 510(k) pre-market clearance from the FDA. Our products have been cleared to be marketed for use with CT, MR and PET scanners. The FDA may not grant clearance with respect to our future products or enhancements, or future FDA review may involve delays that could adversely affect our ability to market such future products or

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enhancements. In addition, the FDA, which is currently under political pressure regarding a handful of products that it cleared over the past few years, including some products that are used for medical imaging, is reviewing the process by which it grants clearance to products. Several of the potential changes could make the process to obtain regulatory clearance more difficult, lengthy and expensive. A more difficult and expensive regulatory clearance process, in addition to potentially causing us to defer or choose not to conduct promising areas of research and development, would by itself slow the time by which products for patient care reach market and could materially and adversely affect our business and results of operations. Further, these changes could affect our products as well as the scanning equipment that produce the data from which our products produce images. If the process becomes more difficult and expensive, medical device manufacturers, including scanning and imaging companies, could increase prices to compensate for the additional risks and costs. Increased prices could further reduce demand for our products, which would materially and adversely affect our business, results of operations and financial condition.

Even if we obtain regulatory clearances and approvals to market a product from the FDA, these approvals may entail limitations on the indicated uses of the product. Product clearances and approvals by the FDA can also be withdrawn due to failure to comply with regulatory standards or the occurrence of unforeseen problems following initial approval. The FDA could also limit or prevent the distribution of our products and has the power to require the recall of such products. FDA regulations depend heavily on administrative interpretation, and future interpretations made by the FDA or other regulatory bodies may adversely affect us. The FDA may inspect our facilities and operations to determine whether we are in compliance with various regulations relating to specification, development, documentation, validation, testing, quality control and product labeling. If the FDA determines that we are in violation of such regulations, it could impose civil penalties, including fines, recall or seize products and, in extreme cases, impose criminal sanctions. If we determine that our facilities, operations or products are not in compliance with FDA requirements, we may voluntarily suspend our operations or recall products.

We market our products both domestically and internationally. International regulatory bodies have established varying regulations governing product standards, packaging requirements, labeling requirements, import restrictions, tariff regulations, duties and tax requirements. Our inability or failure to comply with the varying regulations, or the imposition of new regulations, could restrict our ability to sell our products internationally and could adversely affect our business.

The imposition of requirements under the Health Insurance Portability and Accountability Act of 1996, or HIPAA, could adversely affect our business.

The HIPAA regulations require our customers to observe several requirements for the privacy and security of the protected health information (PHI) of their patients. Although the products and services we provide may technically not be covered under the HIPAA regulations, we may have access to PHI while working with our customers and our customers therefore routinely request that we sign business associate agreements with them. A business associate is a person or entity that performs certain functions or activities that involve the use or disclosure of protected health information on behalf of, or that provides services to, a covered entity. By law, the HIPAA Privacy Rule applies only to covered entities health plans, healthcare clearinghouses, and certain healthcare providers. However, most healthcare providers do not carry out all of their healthcare activities and functions by themselves. Instead, they often use the services of a variety of other persons or businesses. The HIPAA Privacy Rule allows covered providers and health plans to disclose protected health information to these business associates if the providers or plans obtain satisfactory assurances that the business associate will use the information only for the purposes for which it was engaged by the covered entity, will safeguard the information from misuse, and will help the covered entity comply with some of the covered entity s duties under the HIPAA Privacy Rule. Covered entities may disclose protected health information to an entity in its role as a business associate only to help the covered entity carry out its healthcare functions not for the business associate s independent use or purposes, except as needed for the proper management and administration of the business associate. These agreements are necessary for us in the normal course of servicing and supporting our products and may require us to incur liabilities if we disclose protected health information in a manner not allowed under any respective agreement. Our potential liabilities may include indemnifying our customer against any damages resulting from the disclosure. If we are not willing to or are unable to enter into a business associate agreement with current and potential customers, such customers may not purchase our products or services or discontinue previously-purchased services, which would have a material adverse effect on our business, financial condition, or results of operations.

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We are subject to various federal and state fraud and abuse laws, and if we are unable to fully comply with such laws, we could face substantial penalties, which may adversely affect our business.

We are subject to various federal and state laws pertaining to health care fraud and abuse, including HIPAA and the following:

- the federal Anti-Kickback Statute, which prohibits persons from knowingly and willfully soliciting, offering, receiving or providing remuneration, directly or indirectly, in cash or in kind, to induce either the referral of an individual, or furnishing or arranging for a good or service, for which payment may be made under federal health care programs (such as Medicare and Medicaid);

- the federal False Claims Act, which prohibits anyone from knowingly presenting or causing to be presented a false or fraudulent claim for payment to the federal government;

- the federal False Statements Statute, which prohibits knowingly and willfully falsifying, concealing or covering up a material fact or making any materially false statement in connection with the delivery of or payment for health care benefits, items or services; and

- state law equivalents to these federal laws, which may not be limited to government reimbursed items, and may not contain identical exceptions.

If our past or present operations are found to be in violation of any of the laws described above or the other similar governmental regulations to which we are subject, we may be subject to the applicable penalty associated with the violation, including civil and criminal penalties, damages, fines, exclusion from federal health care programs and/or the curtailment or restructuring of our operations. Similarly, if the physicians or other providers or entities with which we do business are found to be non-compliant with applicable laws, they may be subject to sanctions, which could also have a negative impact on us. Any penalties, damages, fines, curtailment or restructuring of our operations could adversely affect our ability to operate our business and our financial results. The risk of our being found in violation of these laws is increased by the fact that their provisions are open to a variety of interpretations and are subject to further legal or regulatory change. Any action against us for violation of these laws, even if we successfully defend against it, could cause us to incur significant legal expenses, fines and other penalties, divert our management s attention from the operation of our business and damage our reputation.

The protection of our intellectual property may be uncertain, and we may face possible claims of others.

Although we have received patents and have filed patent applications with respect to certain aspects of our technology, we generally do not rely principally on patent protection with respect to our products and technologies. Instead, we rely primarily on a combination of trade secret and copyright law, employee and third-party nondisclosure agreements and other protective measures to protect intellectual property rights pertaining to our products and technologies. Such measures may not provide meaningful protection of our trade secrets, know-how or other intellectual property in the event of any unauthorized use, misappropriation or disclosure. Others may independently develop similar technologies or duplicate our technologies. In addition, to the extent that we apply for any patents, such applications may not result in issued patents or, if issued, such patents may not be valid or of value. Third parties could, in the future, assert infringement or misappropriation claims against us with respect to our current or future products and technologies, or we may need to assert claims of infringement against third parties. Any infringement or misappropriation claim by us or against us could place significant strain on our financial resources, divert management s attention from our business and harm our reputation. The costs of prosecuting or defending an intellectual property claim could be substantial and could adversely affect our business, even if we are ultimately successful in prosecuting or defending any such claims. If our products or technologies are found to infringe the rights of a third party, we could be required to pay significant damages or license fees or cease production, any of which could have a material adverse effect on our business.

We face the risk of product liability claims, and our product liability and errors and omissions insurance coverage may not be adequate to pay products liability claims, which could have a material adverse effect on our financial condition.

Our business exposes us to the risk of product liability claims that is inherent in the manufacturing and marketing of medical devices, including those which may arise from the misuse or malfunction of, or design flaws in, our products. We may be subject to product liability claims if our products cause, or merely appear to have caused, an injury. Claims may be made by patients, healthcare providers or others selling our products. Our product liability

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and errors and omissions insurance is subject to deductibles and coverage limitations. Our current product liability insurance may not continue to be available to us on acceptable terms, if at all, and, if available, the coverages may not be adequate to protect us against any future product liability claims. Further, if additional products are approved for marketing, we may seek additional insurance coverage. If we are unable to obtain insurance at an acceptable cost or on acceptable terms with adequate coverages or otherwise protect against potential product liability claims, we will be exposed to significant liabilities, which may harm our business. A product liability claim, recall or other claim with respect to uninsured liabilities or for amounts in excess of insured liabilities could result in significant costs and damage to our reputation and future results, any of which would cause significant harm to our business.

If we fail to attract and retain qualified personnel, our business would be harmed.

Recruiting and retaining talented personnel is critical to our success. There is intense competition from other companies, research and academic institutions, government entities and other organizations for qualified personnel in the areas of our activities. We are located in Minnesota, but compete with companies nationally for employees, particularly those with unique skill sets, and not all potential employees view moving to Minnesota favorably. Further, the pace of change in our industry is rapid, and to keep pace we need to ensure that our existing employees continually upgrade their knowledge and skills. If we fail to identify, attract, retain and motivate these highly skilled personnel, we may be unable to continue our marketing and development activities and may experience interruptions or delays in the execution of our overall business strategy.

We depend on third-party reimbursement. A reduction or other change in reimbursement from third parties could negatively affect our business.

Our products are purchased by hospitals, clinics, imaging centers and other users, which bill various third-party payers, such as government health programs, private health insurance plans, managed care organizations and other similar programs, for the healthcare goods and services provided to their patients. There are currently Current Procedural Terminology, or CPT, reimbursement codes that describe most of the diagnostic procedures that use our products. However, the amount of reimbursement from third-party payers varies by site of service and geographic location and is subject to change. Payers may deny reimbursement if they determine that a product used in a procedure was not used in accordance with established payer protocol regarding cost-effective treatment methods or was used for an unapproved indication. Third-party payers are increasingly challenging the prices charged for medical services and, in some instances, have put pressure on service providers to lower their prices or reduce their services. We are unable to predict what changes will be made in the reimbursement methods used by third-party healthcare payers. Third-party payers may not consider as cost effective the procedures in which our products are used. Reimbursement for such procedures may not be available or, if available, payers low reimbursement levels may adversely affect our ability to sell our products on a profitable basis. In addition, there have been and may continue to be changes and proposals by legislators, regulators and third-party payers to curb further these costs in the future. For example, the Deficit Reduction Act of 2005, or the DRA, which was signed into law on February 8, 2006, imposed caps on Medicare payment rates for certain imaging services, including MR and PET, furnished in physicians offices and other non-hospital based settings. Under the caps, payments for specified imaging services cannot exceed the hospital outpatient payment rates for these services. Enactment of the DRA appeared to significantly affect one segment of our customer base, the standalone imaging center, and also appeared to reduce demand for imaging products among other segments of our customer base. A failure by hospitals and other users of our products to obtain reimbursement from third-party payers, changes in third-party payers policies toward reimbursement for procedures using our products, or legislative action could have a material adverse effect on our business, financial condition and results of operations.

Healthcare reform may negatively impact our business.

The levels of revenue and profitability of medical technology companies may be affected by the efforts of government and third-party payers to contain or reduce the costs of healthcare through various means. In the United States, there has been, and we expect that there will continue to be, a number of federal, state and private proposals to control healthcare costs. These proposals include legislative, regulatory and other initiatives and may contain measures intended to control public and private spending on healthcare as well as to provide universal public access to the healthcare system. If enacted, these proposals may result in a substantial restructuring of the healthcare delivery system. For example, the Congressional Budget Office has issued a report suggesting that radiology benefit managers could require pre-authorization, which could decrease the demand for imaging services. Further, proposals during 2009 included a tax that would be assessed against medical device companies. If such a tax is enacted at

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rates discussed at various times, the amount we would owe could be a significant portion of our cash flows from operations. Significant changes in the nation s healthcare system could have a substantial impact on the manner in which we conduct business and could have a material adverse effect on our business, financial condition and results of operations.

Consolidation in the healthcare industry could lead to demands for price concessions or limit or eliminate our ability to sell to certain of our significant market segments.

The cost of healthcare has risen significantly over the past decade, and numerous initiatives and reforms initiated by legislators, regulators and third-party payers to curb these costs have resulted in a consolidation trend in the medical device industry, as well as among our customers, including healthcare providers. This consolidation has resulted in greater pricing pressures and limitations on our ability to sell to important market segments, as group purchasing organizations, independent delivery networks and large single accounts, such as the Veterans Administration in the United States, continue to consolidate purchasing decisions for some of our healthcare provider customers. We expect that market demand, government regulation, third-party reimbursement policies and societal pressures will continue to change the worldwide healthcare industry, resulting in further business consolidations and alliances which may exert further downward pressure on the prices of our products and adversely impact our business, financial condition and results of operations.

We may incur goodwill impairment charges that adversely affect our operating results.

We review goodwill for impairment annually and more frequently if events and circumstances indicate that the asset may be impaired and that the carrying value may not be recoverable. We operate as one reporting unit and therefore compare our book value to our market value (consisting of market capitalization plus a control premium of 25%). If the market value exceeds the book value, goodwill is generally considered not to be impaired.

Failure of the global economy to recover from the recent downturn, or an extended delay in this recovery, may adversely impact our ability to improve our financial results and grow our business.

We have been affected by the general decline in the global economy, which resulted in contracted capital spending by hospitals and lower interest rates on our cash and investments. Disruptions in the financial markets and the related economic downturn also negatively impacted customer purchasing and payment patterns. Failure of the global economy to recover from this prolonged downturn, or an extended delay in this recovery, may have a material adverse effect on our financial condition and results of operations.

We may issue shares of preferred stock without the consent of our holders of common stock, which could adversely affect the rights of the holders of our common stock.

Our Articles of Incorporation authorize our Board of Directors, without any action by the holders of our common stock, to establish the rights and preferences of up to 5,000,000 shares of currently undesignated preferred stock. These shares of preferred stock could possess voting and conversion rights that could adversely affect the voting power of the holders of the common stock or dilute their ownership rights, and it

may have the effect of delaying, deferring or preventing a change in control of Vital Images. No shares of preferred stock or other senior equity securities are currently designated, and currently we have no plan to designate or issue any such securities.

We are subject to certain laws and plans which may discourage takeover attempts that could be beneficial for shareholders.

We are subject to anti-takeover provisions of the Minnesota Business Corporation Act. These provisions may deter or discourage takeover attempts and other changes in control that are not approved by our Board of Directors, and they may have a depressive effect on any market for our stock. As a result, our shareholders may lose opportunities to dispose of their shares at the higher prices typically available in takeover attempts or that may be available under a merger proposal. In addition, these provisions may have the effect of permitting our current directors to retain their positions and place them in a better position to resist changes that our shareholders may wish to make if they are dissatisfied with the conduct of our business.

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We have never paid any cash dividends and this practice is expected to continue which means appreciation in our stock price will be our shareholders only opportunity to achieve a return on their investment in our common stock.

We have not paid cash dividends on our common stock in the past, and we do not intend to do so in the foreseeable future. Consequently, appreciation in the market price of our common stock and the ability to sell shares at a profit represents our shareholders only opportunity to achieve a return on their investment.

Item 1B. Unresolved Staff Comments

None.

Item 2. Properties

Our principal office is located in an office building in Minnetonka, Minnesota, where we currently occupy approximately 72,000 square feet under a lease that expires January 31, 2012. We also lease small offices in Den Haag, the Netherlands, and Beijing, China, for our operations in those countries. We consider our current facilities adequate for our current needs.

Item 3. Legal Proceedings

We are involved in various claims and legal actions in the normal course of business. We are of the opinion that the outcome of such legal actions will not have a significant adverse effect on our financial position, results of operations or cash flows. Notwithstanding our belief, an unfavorable resolution of some or all of these matters could materially affect our future results of operations or cash flows.

Item 4. Reserved

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Part II

Item 5. Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Vital Images, Inc. s common stock is quoted on The NASDAQ Global Select Market under the symbol VTAL. The table below reflects the high and low per share sale prices of our common stock as reported by The NASDAQ Global Select Market for each of the periods indicated. Such prices reflect inter-dealer prices, do not include adjustments for retail mark-ups, markdowns or commissions, and may not necessarily represent actual transactions.

	High	Low
2009		
Fourth Quarter	$ 13.18	$ 11.35
Third Quarter	$ 13.75	$ 10.19
Second Quarter	$ 12.25	$ 9.64
First Quarter	$ 14.29	$ 8.54
2008		
Fourth Quarter	$ 15.24	$ 10.23
Third Quarter	$ 16.95	$ 11.86
Second Quarter	$ 17.13	$ 12.43
First Quarter	$ 18.72	$ 13.89

We have never paid or declared any cash dividends on our common stock and do not intend to pay dividends on our common stock in the foreseeable future. We expect to retain our future anticipated earnings to finance development and expansion of our business. As of February 28, 2010, there were approximately 5,900 beneficial owners and approximately 500 registered holders of record of our common stock.

On May 8, 2008, we announced a share repurchase program of up to $25.0 million of our common stock. On August 7, 2008, we announced additional repurchases of up to $15.0 million of our common stock. On March 3, 2009, we announced additional repurchases of up to 1.0 million shares of our common stock. As of December 31, 2009, we had purchased 3.3 million shares of our common stock for $44.3 million through only open market transactions. The active share repurchase program expires on March 1, 2011.

The following table presents information with respect to purchases of our common stock made during the quarter ended December 31, 2009 by us or our affiliated purchaser, as defined in Rule 10b-18(a)(3) under the Securities Exchange Act of 1934.

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
October 1-31, 2009		N/A		587,608
November 1-30, 2009		N/A		587,608

December 1-31, 2009	N/A	587,608
	N/A	587,608

Performance Graph

Since April 24, 2007, our common stock has been quoted on The NASDAQ Global Select Market. From June 9, 2003 through April 23, 2007, our stock was quoted on The NASDAQ Global Market. From September 29, 2000 through June 6, 2003, our common stock was quoted on The NASDAQ SmallCap Market (now known as The NASDAQ Capital Market). The following graph shows changes during the period from December 31, 2004 to

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December 31, 2009 in the value of $100 invested in: (1) Vital Images, Inc. s common stock; (2) the Total Return Index for The NASDAQ Composite; and (3) NASDAQ Non-Financial Stocks. The values of each investment as of the dates indicated are based on share prices plus any dividends paid in cash, with the dividends reinvested on the date they were paid. The calculations exclude trading commissions and taxes.

Notwithstanding anything to the contrary set forth in any of our previous or future filings under the Securities Act of 1933 or the Securities Exchange Act of 1934 that might incorporate future filings by reference, including this Annual Report on Form 10-K, in whole or in part, the following performance graph shall not be deemed to be incorporated by reference into any such filings and shall not otherwise be deemed filed under such acts.

COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN*

Among Vital Images, Inc., The NASDAQ Composite Index

And The NASDAQ Non-Financial Index

*$100 invested on 12/31/04 in stock or index, including reinvestment of dividends.

Fiscal year ending December 31.

	12/31/04	12/31/05	12/31/06	12/31/07	12/31/08	12/31/09

Vital Images, Inc.	$	100.00	$	156.12	$	207.76	$	107.88	$	83.04	$	75.76
NASDAQ Composite	$	100.00	$	101.33	$	114.01	$	123.71	$	73.11	$	105.61
NASDAQ Non-Financial	$	100.00	$	100.95	$	111.39	$	120.56	$	70.46	$	105.88

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Item 6. Selected Financial Data (in thousands, except per share data)

	2009 (1)	2008 (1)	2007 (1)	2006 (1)	2005 (1)
Years ended December 31:					
Revenue	$ 58,230	$ 68,141	$ 70,176	$ 70,512	$ 51,717
Gross profit	44,025	52,268	54,587	56,302	40,157
Operating expenses	52,036(2)	62,093(4)	61,755(5)	49,371	32,592(6)
Operating (loss) income	(8,011)	(9,825)	(7,168)	6,931	7,565
Net (loss) income	$ (21,252)(3)	$ (2,800)	$ 1,367	$ 6,583	$ 5,801
Net (loss) income per share-basic	$ (1.48)	$ (0.17)	$ 0.08	$ 0.49	$ 0.47
Weighted average common shares	14,315	16,155	16,972	13,463	12,379
Net income per share-diluted	$ (1.48)	$ (0.17)	$ 0.08	$ 0.46	$ 0.44
Weighted average common shares	14,315	16,155	17,457	14,259	13,283
At December 31:					
Working capital	$ 121,034	$ 135,417	$ 173,905	$ 162,202	$ 45,604
Total assets	$ 172,062	$ 198,193	$ 230,996	$ 219,730	$ 91,151
Long-term debt	$	$	$	$	$
Total stockholders equity	$ 146,722	$ 168,691	$ 202,216	$ 190,902	$ 68,789

(1) Includes equity-based compensation of $3,867, $5,007, $5,987, $5,063 and $335 for the fiscal years 2009, 2008, 2007, 2006 and 2005, respectively.

(2) Includes a $3,147 asset impairment charge related to the implementation of the Company s enterprise resource planning system in the second quarter of 2009.

(3) Includes a $14,964 non-cash charge to the provision for income taxes to establish a full valuation allowance against the Company s deferred tax assets in the second quarter of 2009.

(4) Includes a $660 restructuring charge related to a reduction in workforce of approximately 11% in November 2008.

(5) Includes an $885 charge related to the separation of Jay D. Miller, our former Chief Executive Officer, in the fourth quarter of 2007.

(6) Includes a loss on operating lease of $493 related to the relocation of our corporate headquarters in the first quarter of 2005.

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Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations

Executive summary

The financial results for Vital Images, Inc. (also referred to as we , us and our) have continued to be affected by the general decline in the U.S. economy, which has resulted in contracted capital spending by U.S. hospitals and lower interest rates on our cash and investments. Additionally, we have been impacted by weakness in the high-end computed tomography, or CT, and picture archiving and communication systems, or PACS, markets. We mitigated these negative factors through significant cost-control measures, while continuing to make strategic investments. Vital Images, Inc. summary 2009 results were as follows:

- Total revenue of $58.2 million, compared to $68.1 million for 2008 and $70.2 million for 2007.
- Gross margin of 75.6%, compared to 76.7% for 2008 and 77.8% for 2007.
- Operating expenses of $52.0 million, compared to $62.1 million for 2008 and $61.8 million for 2007.
- Operating loss of $8.0 million, compared to $9.8 million for 2008 and $7.2 million for 2007.
- Interest income of $1.1 million, compared to $4.6 million for 2008 and $8.9 million for 2007. A decline in interest rates resulted in a 0.8% return on investment in 2009, compared to 2.9% and 5.1% return on investments in 2008 and 2007, respectively.
- Net loss of $21.3 million, or $(1.48) loss per diluted share, compared to net loss of $2.8 million, or $(0.17) loss per diluted share, for 2008 and net income of $1.4 million, or $0.08 per diluted share, for 2007. The net loss for 2009 included $18.1 million of non-cash charges representing $(1.27) per diluted share.

Total cash, cash equivalents and marketable securities were $142.2 million as of December 31, 2009, compared to $147.0 million as of December 31, 2008. Working capital (defined as current assets less current liabilities) was $121.0 million as of December 31, 2009, compared to $135.4 million as of December 31, 2008. The decrease in cash, cash equivalents and marketable securities during 2009 was primarily the result of repurchases of our common stock totaling $6.1 million under share repurchase programs authorized by our Board of Directors in 2008 and 2009. The decrease in working capital during 2009 was primarily the result of purchases of noncurrent marketable securities, the balance of which increased $12.2 million during 2009.

Overview

We are a leading provider of advanced visualization and analysis solutions for use by medical professionals in clinical analysis and therapy planning for medical conditions. We provide software, customer education, software maintenance and support, professional services and, on occasion, third-party hardware to our customers. Our technology rapidly transforms complex data generated by diagnostic imaging equipment into functional digital images that can be manipulated and analyzed using our specialized applications to better understand internal anatomy and

pathology. Our solutions are designed to improve physician workflow and productivity, enhance the ability to make clinical decisions, facilitate less invasive patient care, and complement often significant capital investments in diagnostic imaging equipment made by our customers. Our software is compatible with equipment from all major manufacturers of diagnostic imaging equipment, such as CT scanners, and can be integrated into PACS. Many hospitals use PACS to acquire, distribute and archive medical images and diagnostic reports, reducing the need for film and increasing reliance on advanced visualization solutions such as ours. We also offer a Web-based solution that provides physicians with anywhere, anytime access to medical images and visualization tools through any Internet-enabled computer.

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

Critical accounting policies and estimates

Our discussion and analysis of financial condition and results of operations are based upon our Consolidated Financial Statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The notes to the Consolidated Financial Statements contained in this Annual Report

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describe our significant accounting policies used in the preparation of the Consolidated Financial Statements. The preparation of these financial statements requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates. We continually evaluate our critical accounting policies and estimates.

We believe the critical accounting policies listed below reflect significant judgments, estimates and assumptions used in the preparation of our Consolidated Financial Statements.

Allowance for doubtful accounts

We maintain an allowance for doubtful accounts in an amount estimated to be sufficient to provide adequate protection against losses resulting from extending credit to our customers. In judging the adequacy of the allowance for doubtful accounts, we consider multiple factors, including historical bad debt experience, the general economic environment, the need for specific client reserves and the aging of our outstanding receivables. A portion of this provision is included in operating expenses as a general and administrative expense and a portion of this provision is included as a reduction of license revenue. 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. As of December 31, 2009, the allowance for doubtful accounts was $736,000 for gross accounts receivable of $12.9 million.

Deferred taxes

Significant judgment is required in determining the realizability of our deferred tax assets. We must assess the likelihood that our net deferred tax assets will be recovered from future taxable income, and to the extent we believe that recovery is not likely, we must establish a valuation allowance. Considerations for determining the realizability of our deferred tax assets primarily involve cumulative pre-tax income for financial reporting purposes, cumulative taxable income for the past three years, estimated future pre-tax income for financial reporting purposes and estimated future taxable income from our core business. We also consider the expiration dates and amounts of net operating loss carryforwards and other tax credits, and estimate the impact of future tax deductions from the exercise of stock options. These estimates are projected through the life of the related deferred tax assets based on assumptions which we believe to be reasonable and consistent with current operating results. After giving consideration to the above factors, during the three months ended June 30, 2009, we recorded a non-cash charge of $15.0 million to the provision for income taxes to establish a full valuation allowance against our deferred tax assets. If pretax results improve in future periods, we may be able to utilize the deferred tax assets to reduce tax payments.

Goodwill

We account for goodwill in accordance with the provisions of Accounting Standards Codification (ASC) Topic 350, *Intangibles Goodwill and Other*. Under this accounting guidance, 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. We operate as one reporting unit and therefore compare the book value to the market value (consisting of market capitalization plus a control premium of 25%). As

of December 31, 2009, we had 14.3 million shares outstanding, a closing stock price of $12.69 per share, a market value of $227.3 million, and a book value of $146.7 million, which would indicate that our goodwill of $9.1 million was not impaired. 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 our 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. If market conditions continue to fluctuate, we may incur goodwill impairment charges that adversely affect our financial position and operating results.

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Revenue Recognition

We follow specific and detailed guidelines in determining the proper amount of revenue to be recorded; however, certain judgments affect the application of our revenue recognition policy.

We recognize revenue in accordance with ASC Topic 985, *Revenue Recognition*. We recognize revenue when it is realized or realizable and earned. We consider revenue realized or realizable and earned when we have 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.

Revenue results are difficult to predict, and any shortfall in revenue or delay in recognizing revenue could cause our operating results to vary significantly from period to period. The significant judgments for revenue recognition typically involve whether collectability can be considered probable and whether fees are fixed or determinable. Significant judgment is also required when evaluating and assessing revenue recognition relating to our distribution agreements with original equipment manufacturers, value-added resellers and independent distributors (collectively, Resellers). In addition, our transactions often consist of multiple element arrangements, which must be analyzed to determine the fair value of each element, the amount of revenue to be recognized upon shipment, if any, and the period and conditions under which deferred revenue should be recognized. As a result, if facts and circumstances change that affect our current judgments, our revenue could be materially different in the future.

Equity-based compensation

We recognize equity-based compensation expense under the fair value recognition provisions of ASC Topic 718, *Compensation Stock Compensation*. We recognize equity-based compensation net of an estimated forfeiture rate and recognize compensation cost only for those shares expected to vest over the requisite service period of the award.

The fair value of each option award is estimated as of the date of grant using the Black-Scholes option valuation model. The Black-Scholes option valuation model requires the development of assumptions that are input into the model. These assumptions are the expected stock volatility, the risk-free interest rate, the option s expected life and the dividend yield on the underlying stock. Expected volatility is calculated based on the historical volatility of our common stock over the expected option life and other appropriate factors. Risk-free interest rates are calculated based on continuously compounded U.S. Treasury risk-free rates for the appropriate term. Prior to March 9, 2006, the expected life of stock options was calculated by performing a detailed analysis of all historical stock option information available. On March 9, 2006, we began to grant options with a five-year legal life instead of the eight-year legal life that had historically been used. As a result, we elected to use the simplified method, to estimate the expected life of options granted on and after March 9, 2006. We will utilize the simplified method until sufficient historical information becomes available on the five-year legal life options. The dividend yield is assumed to be zero, as we have never paid or declared any cash dividends on our common stock and do not intend to pay dividends on our common stock in the foreseeable future. The expected forfeiture rate is estimated based on historical experience.

Determining the appropriate fair value model and calculating the fair value of equity-based payment awards require the input of the subjective assumptions described above. The assumptions used in calculating the fair value of equity-based payment awards represent management s best estimates, which involve inherent uncertainties and the application of management judgment. As a result, if factors change and we use different

assumptions, our equity-based compensation expense could be materially different in the future. In addition, we are required to estimate the expected forfeiture rate and recognize expense only for those shares expected to vest. If our actual forfeiture rate is materially different from our estimate, the equity-based compensation expense could be significantly different from what we have recorded in the current period. See Note 2 to the Consolidated Financial Statements for a further discussion of equity-based compensation.

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Results of Operations

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

	For the Year Ended December 31,		
	2009	2008	2007
Revenue:			
License fees	39.1%	50.3%	56.5%
Maintenance and services	57.9	47.6	42.0
Hardware	3.0	2.1	1.5
Total revenue	100.0	100.0	100.0
Cost of revenue:			
License fees	5.7	7.2	6.7
Maintenance and services	15.9	14.8	14.2
Hardware	2.8	1.3	1.0
Impairment of patent			0.3
Total cost of revenue	24.4	23.3	22.2
Gross profit	75.6	76.7	77.8
Operating expenses:			
Sales and marketing	38.8	40.8	42.0
Research and development	28.1	29.9	26.3
General and administrative	17.1	19.4	19.7
Asset impairment	5.4		
Restructuring charge		1.0	
Total operating expenses	89.4	91.1	88.0
Operating (loss) income	(13.8)	(14.4)	(10.2)
Interest income	1.9	6.8	12.6
(Loss) income before income taxes	(11.9)	(7.6)	2.4
(Benefit) provision for income taxes	24.6	(3.5)	0.5
Net (loss) income	(36.5)%	(4.1)%	1.9%

Revenue (dollars in thousands)

	For the Year Ended December 31,			Increase (Decrease)		Percent Increase (Decrease)	
	2009	2008	2007	2008 to 2009	2007 to 2008	2008 to 2009	2007 to 2008
Revenues:							
License fees	$ 22,766	$ 34,290	$ 39,673	$ (11,524)	$ (5,383)	(34)%	(14)%
Maintenance and services	33,717	32,436	29,487	1,281	2,949	4%	10%

Hardware	1,747	1,415	1,016	332	399	23%	39%
Total revenue	$ 58,230	$ 68,141	$ 70,176	$ (9,911)	$ (2,035)	(15)%	(3)%

Revenue (dollars in thousands) 46

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License fee revenue (dollars in thousands)

The following table sets forth information on license fee revenue by source:

	For the Year Ended December 31,			Increase (Decrease)		Percent Increase (Decrease)	
	2009	2008	2007	2008 to 2009	2007 to 2008	2008 to 2009	2007 to 2008
License fee revenue:							
Direct and other distributors	$ 4,493	$ 11,014	$ 17,532	$ (6,521)	$ (6,518)	(59)%	(37)%
Toshiba	18,273	23,276	22,141	(5,003)	1,135	(21)%	5%
Total license fees	$ 22,766	$ 34,290	$ 39,673	(11,524)	(5,383)	(34)%	(14)%
Percent of license fee revenue:							
Direct and other distributors	20%	32%	44%				
Toshiba	80	68	56				
Total license fee revenue	100%	100%	100%				

The decreases in license fee revenue for 2009 and 2008, compared to 2008 and 2007, respectively, were driven by the general decline in the U.S. economy starting in 2008 and continuing through 2009, which resulted in increased pricing pressures and contracted capital spending by U.S. hospitals.

Maintenance and services revenue (dollars in thousands)

	For the Year Ended December 31,			Increase (Decrease)		Percent Increase (Decrease)	
	2009	2008	2007	2008 to 2009	2007 to 2008	2008 to 2009	2007 to 2008
Maintenance and services revenue:							
Maintenance and support	$ 28,792	$ 26,656	$ 22,811	$ 2,136	$ 3,845	8%	17%
Customer education	3,511	4,478	5,590	(967)	(1,112)	(22)%	(20)%
Professional services	1,414	1,302	1,086	112	216	9%	20%
Total maintenance and services	$ 33,717	$ 32,436	$ 29,487	$ 1,281	$ 2,949	4%	10%

In 2009 and 2008, maintenance and services revenue was positively impacted by sales of our products on an enterprise basis, as a larger percentage of each enterprise sale is allocated to maintenance and services revenue than has historically been allocated for sales of our products on a workstation basis, as enterprise sales carry higher maintenance and services pricing. As was the case in 2009 and 2008, we expect that in future periods, although sales of our enterprise offering will result in proportionately lower license revenue upon sale, we will benefit from a recurring revenue stream from maintenance and services contracts.

The increase in maintenance and support revenue in 2009, compared to 2008, was due to an increase in the number of customers on maintenance contracts resulting from additional license sales. The increase in maintenance and support revenue in 2008, compared to 2007, was primarily driven by an increase in the number of customers on maintenance contracts, resulting from both additional license sales and improvement in the percentage of our existing customers on maintenance contracts.

An overall decrease in the number of license sales in 2009 and 2008, as compared to 2008 and 2007, respectively, contributed to lower customer education revenue in both 2009 and 2008.

Professional services revenue, which includes installation and other implementation-related services, increased in 2009 and 2008, due to increases in professional services resulting from sales of our product on an enterprise basis and the timing of services provided.

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Hardware revenue

Hardware revenue increased 23% to $1.7 million in 2009, compared to $1.4 million in 2008, which was a 39% increase from $1.0 million in 2007. Hardware revenue increased due to the increased sales of our product on an enterprise basis, for which our customers frequently purchase hardware from us. Sales of hardware systems are not core to our strategy and will fluctuate from period to period depending upon the needs of our customers.

Cost of revenue and gross profit

Gross profit decreased 16% to $44.0 million in 2009, compared to $52.3 million in 2008, which was a 4% decrease from $54.6 million in 2007. Gross margin percentage decreased slightly to 75.6% in 2009 from 76.7% in 2008 and 77.8% in 2007, due to pricing pressures on new license sales and a greater percentage of total revenue relating to maintenance and services, which carries lower margins than license fees.

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

	For the Year Ended December 31,			Increase (Decrease)		Percent Increase (Decrease)	
	2009	2008	2007	2008 to 2009	2007 to 2008	2008 to 2009	2007 to 2008
Gross profit:							
License fees	$ 19,465	$ 29,368	$ 34,948	$ (9,903)	$ (5,580)	(34)%	(16)%
Maintenance and services	24,435	22,347	19,559	2,088	2,788	9%	14%
Hardware	125	553	322	(428)	231	(77)%	72%
Impairment of patent			(242)		242	%	(100)%
Total gross profit	$ 44,025	$ 52,268	$ 54,587	$ (8,243)	$ (2,319)	(16)%	(4)%
Gross margin:							
License fees	85.5%	85.6%	88.1%				
Maintenance and services	72.5%	68.9%	66.3%				
Hardware	7.2%	39.0%	31.7%				
Total gross margin	75.6%	76.7%	77.8%				

Fluctuations in license fee gross margin are generally a result of average sales prices, changes in the product mix, and the mix between direct sales and sales to distribution partners, as well as mix between domestic and international sales. License fee gross margin remained relatively flat in 2009, compared to 2008, as a decrease in amortization expense was offset by pricing pressures and an increase, as a percent of total revenue, in sales through our distribution partners, which have lower margins. License fee gross margin decreased in 2008, compared to 2007, due to an increase in revenue, as a percent of total revenue, from international sales through our distribution partners, which typically have lower margins than U.S. direct sales.

Maintenance and services gross margin increased during 2009 and 2008, compared to 2008 and 2007, respectively, as a larger percentage of each enterprise sale is allocated to maintenance and services revenue than has historically been allocated for sales of our products on a workstation basis, as enterprise sales carry higher maintenance and services pricing, without a corresponding increase in costs. In addition, in 2009 and 2008, we recognized benefits of $552,000 and $391,000, respectively, to maintenance and support revenue arising from Toshiba billing adjustments. We will continue to invest in our customer education, installation, professional services and customer support areas in the future to adequately support our growing installed base of customers. We had 51, 53 and 55 maintenance and services personnel as of December 31, 2009, 2008 and 2007, respectively.

Gross margin for hardware decreased in 2009, compared to 2008, and increased in 2008, compared to 2007. Variances in gross margin for hardware are expected, as hardware sales are not a substantial part of the sales strategy.

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During the third quarter 2007, we recognized a $242,000 patent impairment charge related to a patent application acquired in the HInnovation, Inc. acquisition in February 2004. This patent application was rejected by the United States Patent and Trademark Office on August 23, 2007, and we decided not to pursue this application further. The impairment was recorded as a separate item in cost of revenue, and it is included in the total gross margin percentage above.

Operating expenses

The following is a comparison of operating expenses as a percent of revenue as well as the percent increase or decrease in the total expense:

	Percent of Revenue for the Year Ended December 31,			Percent Increase (Decrease)	
	2009	2008	2007	2008 to 2009	2007 to 2008
Operating expenses:					
Sales and marketing	38.8%	40.8%	42.0%	(19)%	(6)%
Research and development	28.1	29.9	26.3	(20)%	10%
General and administrative	17.1	19.4	19.7	(25)%	(4)%
Asset impairment	5.4			100%	%
Restructuring charge		1.0		(100)%	100%
Total operating expenses	89.4%	91.1%	88.0%	(16)%	1%

Sales and marketing

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

	For the Year Ended December 31,			Increase (Decrease)		Percent Increase (Decrease)	
	2009	2008	2007	2008 to 2009	2007 to 2008	2008 to 2009	2007 to 2008
Salaries, benefits and bonus	$ 8,841	$ 10,590	$ 9,982	$ (1,749)	$ 608	(17)%	6%
Overhead and other expenses	3,558	4,050	4,306	(492)	(256)	(12)%	(6)%
Commissions	2,050	3,588	4,634	(1,538)	(1,046)	(43)%	(23)%
Travel, meals and entertainment	2,424	3,319	3,450	(895)	(131)	(27)%	(4)%
Trade shows and advertising	2,839	3,422	3,612	(583)	(190)	(17)%	(5)%
Depreciation	1,624	1,601	1,311	23	290	1%	22%
Equity-based compensation	1,243	1,265	2,186	(22)	(921)	(2)%	(42)%
Total	$ 22,579	$ 27,835	$ 29,481	$ (5,256)	$ (1,646)	(19)%	(6)%

The decrease in salaries and benefits costs in 2009, compared to 2008, resulted from decreased average annual headcount. The decrease in commissions expense in 2009, compared to 2008, was due to a decreased amount of direct sales. The decrease in other expense categories in 2009, compared to 2008, was primarily due to decreased headcount and other broad-based cost control measures.

The decrease in expenses in 2008 compared to 2007 was due primarily to a decrease in commission expense related to the decrease in revenue and a decrease in equity-based compensation resulting from issuing equity awards at a lower exercise price, as well as significant cancellations of equity awards resulting from organizational changes.

We had 70, 69 and 89 sales and marketing personnel as of December 31, 2009, 2008 and 2007, respectively. The decrease in headcount as of December 31, 2008 was due primarily to the November 2008 reduction in force described in Restructuring charge.

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Research and development

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

	For the Year Ended December 31,			Increase (Decrease)		Percent Increase (Decrease)	
	2009	2008	2007	2008 to 2009	2007 to 2008	2008 to 2009	2007 to 2008
Salaries, benefits and bonus	$ 11,814	$ 13,024	$ 12,483	$ (1,210)	$ 541	(9)%	4%
Overhead and other expenses	3,535	3,607	3,406	(72)	201	(2)%	6%
Equity-based compensation	945	1,179	949	(234)	230	(20)%	24%
Depreciation	869	1,044	1,140	(175)	(96)	(17)%	(8)%
Consulting	307	1,501	498	(1,194)	1,003	(80)%	201%
Development reimbursement	(1,138)			(1,138)		100%	%
Total	$ 16,332	$ 20,355	$ 18,476	$ (4,023)	$ 1,879	(20)%	10%

The decrease in research and development expenses in 2009, compared to 2008, was due to reduced headcount resulting from our November 2008 reduction in force, lower utilization of consultants and other cost control measures. Additionally, during the 2009 first quarter, we entered into a development agreement with Toshiba, under which Toshiba provides funding in support of our research and development efforts, and the parties work collaboratively to develop and deliver innovative technology advancements for Toshiba s medical equipment and our advanced visualization software solutions. In 2009, we recognized a credit of $1.1 million to our research and development expenses for reimbursement from Toshiba for development costs we incurred under the co-development agreement. The decrease in other expense categories in 2009, compared to 2008, was primarily due to decreased headcount and other broad-based cost control measures.

The major driver of higher research and development expenses in 2008 was new product initiatives, resulting in increased consulting expense and increased compensation expense due to higher average headcount in 2008 compared to 2007.

We had 87, 114 and 134 research and development personnel as of December 31, 2009, 2008 and 2007, respectively. The decrease in headcount as of December 31, 2009, was due primarily to the termination of 20 employees in our Beijing office in August 2009 in conjunction with our decision to discontinue test and product development activities in Beijing. The decrease in headcount as of December 31, 2008 was due primarily to the reduction in force described in Restructuring charge.

General and administrative

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

	For the Year Ended December 31,			Increase (Decrease)		Percent Increase (Decrease)	
	2009	2008	2007	2008 to 2009	2007 to 2008	2008 to 2009	2007 to 2008
Salaries, benefits and bonus	$ 4,582	$ 4,583	$ 5,211	$ (1)	$ (628)	(0)%	(12)%
Overhead and other expenses	2,355	3,335	2,943	(980)	392	(29)%	13%
Professional and consulting services	1,685	3,095	3,181	(1,410)	(86)	(46)%	(3)%
Equity-based compensation	1,356	2,230	2,463	(874)	(233)	(39)%	(9)%
Total	$ 9,978	$ 13,243	$ 13,798	$ (3,265)	$ (555)	(25)%	(4)%

The decrease in general and administrative expenses in 2009, compared to 2008, was due in part to a lower utilization of consultants and reduced headcount resulting from the November 2008 reduction in force. Equity-based compensation decreased in 2009, compared to 2008, as previously issued equity awards became fully vested and as headcount decreased. The decrease in other expense categories in 2009, compared to 2008, was primarily due to decreased headcount and other broad-based cost control measures.

Salaries, benefits and bonus and equity-based compensation decreased for 2008, compared to 2007, as 2007 included an $885,000 pre-tax charge related to the separation of our former Chief Executive Officer. Of this charge,

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$580,000 is included in salaries, benefits and bonus and $305,000 is included in equity-based compensation for 2007. Overhead expenses increased in 2008, compared to 2007, due to the increase in infrastructure.

We had 38, 44 and 49 general and administrative personnel as of December 31, 2009, 2008 and 2007, respectively. Decreases in headcount were the result of our cost-control measures.

Asset impairment

In 2007, we began the implementation of an enterprise resource planning (ERP) system. The ERP system was intended to replace numerous disconnected business management software applications and link the data contained within these disconnected systems to enable better management of our business and derive more useful data for various business functions, such as sales, marketing, finance and customer support.

Phase 1 of the implementation, which related to the replacement of our general ledger, was completed in 2007. The related capitalized costs are being depreciated over seven years and, as of December 31, 2009, the net book value of Phase 1 was $626,000. Phase 2 of the implementation, which consisted of replacing our various customer relationship management and order processing systems, was put on hold in 2008 in conjunction with our cost-control efforts, and we did not capitalize any costs relating to Phase 2 subsequent to October 2008. During the three months ended June 30, 2009, we determined, in conjunction with continued cost-control measures, that we would not implement Phase 2. As a result, in 2009 we recognized an asset impairment charge of $3.1 million related to the Phase 2 implementation.

Restructuring charge

During 2008, we continued to experience the effects of the industry-wide slowdown in the high-end CT market and the Deficit Reduction Act that significantly impacted our 2007 results. Additionally, in 2008, we were impacted by the general decline in the U.S. economy, which resulted in contracted capital spending by U.S. hospitals and lower interest rates on our cash and investments. We reduced our workforce by approximately 11% under a plan announced in November 2008 in order to align our operations with the current market conditions and improve profitability in 2009 and beyond.

In connection with the reduction in workforce, we incurred certain charges in 2008 totaling $660,000, which were primarily comprised of employee severance and other termination costs. The following table summarizes 2009 and 2008 restructuring transactions and related liability balances (in thousands):

	Severance and Other Termination Costs
Balance at January 1, 2008	$
Restructuring charges	660

Payments	(519)
Balance at December 31, 2008	141
Payments	(141)
Balance at December 31, 2009	$

Actions with respect to the above activities were completed in the fourth quarter of 2008, and we did not incur any significant additional charges in 2009 related to the restructuring plan announced in November 2008.

Interest income

We generated $1.1 million of interest income in 2009, compared to $4.6 million in 2008 and $8.9 million in 2007. A decline in interest rates resulted in a 0.8% return on investments in 2009, compared to a 2.9% and 5.1% return on investments in 2008 and 2007, respectively.

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Interest income is significantly impacted by changes in interest rates. We do not anticipate a significant improvement in interest rates in 2010 compared to 2009 due to general market conditions; interest rate changes may have a significant impact on results.

Income taxes

During the three months ended June 30, 2009, we recorded a non-cash charge of $15.0 million to the provision for income taxes to establish a full valuation allowance against our deferred tax assets based on our assessment of cumulative pretax results in recent years and projections of cumulative pretax results in future periods.

During 2009, we recognized $194,000 in one-time tax benefits resulting from tax legislation, which enabled us to receive cash payment for the monetization of certain historic research and development tax credits. Also as a result of the legislation, we recognized a $248,000 one-time tax benefit related to the refund of certain alternative minimum tax payments in prior years.

For 2010, we anticipate a consolidated tax provision of approximately $20,000 per quarter relating entirely to foreign operations.

Liquidity and capital resources

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

	As of December 31,	
	2009	2008
Cash and cash equivalents	$ 120,317	$ 109,706
Marketable securities	21,907	37,287
Cash, cash equivalents and marketable securities	$ 142,224	$ 146,993
Working capital	$ 121,034	$ 135,417
Debt	$	$

The decrease in our cash, cash equivalents and marketable securities as of December 31, 2009, compared to December 31, 2008, was primarily the result of repurchases of our common stock totaling $6.1 million under share repurchase programs authorized by our Board of Directors in 2008 and 2009. The decrease in working capital during 2009 was primarily the result of purchases of noncurrent marketable securities, the balance of which increased $12.2 million during 2009.

We believe our existing cash and investments will satisfy our foreseeable working capital requirements for at least the next 12 months. Additionally, we believe our liquidity and strong balance sheet enable us to execute our repurchases of common stock while still investing in our

enterprise solution and marketing strategy and remaining well positioned to pursue strategic acquisitions if and when they emerge.

We have investments in marketable securities that are classified and accounted for as available-for-sale. As of December 31, 2009, $9.7 million of our marketable securities mature within one year and the remaining $12.2 million of our marketable securities mature in 2011.

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Summary of Cash Flows

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

	For the Year Ended December 31,		
	2009	**2008**	**2007**
Cash provided by (used in)			
Operating activities	$ 2,374	$ 8,581	$ 13,902
Investing activities	12,668	(10,246)	(15,870)
Financing activities	(4,431)	(35,314)	4,271
Net change in cash and cash equivalents	$ 10,611	$ (36,979)	$ 2,303

Operating activities

Net cash provided by operating activities decreased $6.2 million to $2.4 million in 2009, compared to $8.6 million in 2008, due to an $18.4 million increase in net loss and a $7.3 million decrease from changes in operating assets and liabilities, offset by an $19.5 million increase in non-cash operating items. The $7.3 million decrease in net cash from changes in operating assets and liabilities was primarily due to decreased sales and expenses in 2009, compared to 2008, and to the timing of receipts and payments in the ordinary course of business. Cash provided by non-cash operating items increased by $19.5 million in 2009 to $27.2 million, compared to $7.6 million in 2008, primarily resulted from a $14.7 million decrease in deferred tax assets due to a $15.0 million valuation allowance recorded in the second quarter of 2009 and a $3.1 million asset impairment in the second quarter of 2009.

Net cash provided by operating activities decreased $5.3 million in 2008 to $8.6 million, compared to $13.9 million in 2007, due to a $4.2 million decrease in net income and a $1.9 million decrease in non-cash operating items, offset by a $791,000 increase due to the timing of other receipts and payments in the ordinary course of business.

Investing activities

Net cash provided by investing activities was $12.7 million in 2009, compared to cash used by investing activities of $10.2 million in 2008 and $15.9 million in 2007.

We used $21.7 million, $76.4 million and $60.0 million to purchase investments in marketable securities during 2009, 2008 and 2007, respectively. We realized $36.8 million, $71.6 million and $50.7 million of proceeds from maturities and sales of marketable securities during 2009, 2008 and 2007, respectively. As of December 31, 2009, the marketable securities consist of U.S. government obligations and corporate commercial obligations.

We used $2.3 million, $5.4 million and $6.6 million for purchases of property and equipment in 2009, 2008 and 2007, respectively. The purchases for all periods were principally to upgrade computer equipment and to purchase computer equipment for new personnel. Purchases for 2008 and 2007 also included costs related to expanding our facilities. Additionally, in 2007, we began the implementation of an enterprise resource planning (ERP) system. We continued implementation of the ERP during 2008 and 2009, though we recognized an impairment charge related to Phase 2 in the second quarter of 2009, as noted in the Asset impairment section above. We anticipate that we will continue to purchase property and equipment in the normal course of business. The amount and timing of these purchases and the related cash outflows in future periods are difficult to predict and depend on a number of factors, including the hiring of employees and the rate of change of computer hardware.

Financing activities

Cash used by financing activities totaled $4.4 million and $35.3 million in 2009 and 2008, respectively, compared to cash provided by financing activities of $4.3 million in 2007. The primary use of cash in 2009 and 2008 was for the

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repurchase of $6.1 million and $38.2 million of our common stock, respectively, under our share repurchase programs. The cash provided by financing activities in 2007 resulted primarily from the exercise of stock options granted under our stock plans and upon the exercise of warrants.

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

The following summarizes our contractual obligations at December 31, 2009 and the effect such obligations are expected to have on our liquidity and cash flow in future periods (in thousands).

	Total	Less than 1 Year	1 to 3 Years	3 to 5 Years	More than 5 Years
Operating leases	$ 2,228	$ 1,026	$ 1,202	$	$

Off-balance-sheet arrangements

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

Purchase commitments

We had no significant outstanding purchase commitments as of December 31, 2009. We have entered into a number of technology licensing agreements that provide for the payment of royalties when we sell our software products; we are not obligated for any minimum payments under such agreements.

Foreign currency transactions

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

Inflation

We believe inflation has not had a material effect on our operations or financial condition.

Recent accounting pronouncements

Information regarding new accounting pronouncements is included in Note 2 to the Consolidated Financial Statements.

Item 7A. Quantitative and Qualitative Disclosures about Market Risk

Market risk refers to the risk that a change in the level of one or more market prices, interest rates, indices, volatilities, correlations or other market factors such as liquidity will result in losses for a certain financial instrument or group of financial instruments. We do not hold or issue financial instruments for trading purposes, and we do not enter into forward financial instruments to manage and reduce the impact of changes in foreign currency rates because, as disclosed above, our export sales are primarily negotiated, invoiced and paid in U.S. dollars, with a small percentage of sales transactions denominated in foreign currencies. Based on the controls in place and the relative size of the financial instruments entered into, we believe the risks associated with not using these instruments would not have a material adverse effect on our consolidated financial position or results of operations.

In addition, we do not engage in speculative transactions and do not use derivative instruments or engage in hedging activities. See the Notes to the Consolidated Financial Statements for a description of our accounting policies and other information related to these financial instruments.

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In the normal course of business, we are exposed to market risks, including changes in interest rates and price changes, which could affect our operating results.

Interest rate risk

We place our cash, cash equivalents and marketable securities with a high-quality financial institution and have investment guidelines relative to diversification and maturities designed to maintain safety and liquidity. As of December 31, 2009, we had cash, cash equivalents and marketable securities totaling $142.2 million. If, during 2009, average short-term interest rates decreased by 0.5% from 2009 average rates, based on our quarterly average balance of cash, cash equivalents and marketable securities, our interest income from short-term investments would have decreased by approximately $690,000.

Foreign currency risk

Our export sales are primarily negotiated, invoiced and paid in U.S. dollars, with a portion of sales transactions denominated in foreign currencies. Therefore, fluctuations in the value of the dollar as compared to other foreign currencies have not had a significant effect on our results of operations or financial condition. As we expand our direct business internationally, we expect to enter into a higher percentage of sales transactions in foreign currencies and could be subject to greater gains or losses based on exchange rate fluctuations.

Item 8. Financial Statements and Supplementary Data

Our financial statements and Report of Independent Registered Public Accounting Firm thereon, all of which are included in this Annual Report on Form 10-K, are listed in Item 15(a)(1) of this Form 10-K.

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

Not applicable.

Item 9A. Controls and Procedures

Evaluation of disclosure controls and procedures

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

Our management, under the supervision of and with the participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, as of the end of the period covered by this report. Based on such evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of the period covered by this report, our disclosure controls and procedures were effective.

Management s report on internal control over financial reporting

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

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Our management, under the supervision of and with the participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our internal control over financial reporting as of the end of the period covered by this report based on the criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on the results of this evaluation, we concluded that our internal control over financial reporting was effective as of the end of the period covered by this report.

The effectiveness of our internal control over financial reporting as of December 31, 2009 has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm, as stated in their report which is included in Item 15(a)(1) of this Annual Report on Form 10-K.

Changes in internal control over financial reporting

There were no changes in internal control over financial reporting during the quarter ended December 31, 2009 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Item 9B. Other Information

None.

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Part III

Certain information required by Part III is omitted from this Annual Report on Form 10-K because we will file a definitive Proxy Statement relating to our 2010 Annual Meeting of Stockholders pursuant to Schedule 14A (the Proxy Statement) not later than 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K, and certain information included therein is incorporated herein by reference as indicated below.

Item 10. Directors, Executive Officers and Corporate Governance

The information required by this Item 10 will be included under the captions Election of Directors and Information Concerning Directors, Nominees and Executive Officers in our Proxy Statement for our 2010 annual meeting of shareholders. Information concerning the compliance of our officers, directors and 10% shareholders with Section 16(a) of the Securities Exchange Act of 1934 is incorporated by reference to the information to be contained in the 2010 proxy statement under the caption Information Concerning Directors Nominees and Executive Officers Section 16(a) Beneficial Ownership Reporting Compliance. The information regarding Audit Committee members and Audit Committee Financial Experts is incorporated by reference to the information to be contained in the 2010 proxy statement under the caption Information Concerning Directors Nominees and Executive Officers Board Committees. The information regarding our Code of Business Ethics is incorporated by reference to the information to be contained in the 2010 proxy statement under the heading Information Concerning Directors Nominees and Executive Officers Code of Business Conduct and Ethics.

Item 11. Executive Compensation

The information under the captions Information Concerning Directors, Nominees and Executive Officers Director Compensation, Information Concerning Directors, Nominees and Executive Officers Compensation Discussion and Analysis, Information Concerning Directors, Nominees and Executive Officers Compensation Committee Report, Information Concerning Directors, Nominees and Executive Officers Executive Compensation and Information Concerning Directors, Nominees and Executive Officers Compensation Committee Interlocks and Insider Participation to be contained in the 2010 proxy statement is incorporated herein by reference.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The information under the captions Beneficial Ownership of Common Stock and Information Concerning Directors, Nominees and Executive Officers Securities Authorized for Issuers Under Equity Compensation Plans to be contained in the 2010 proxy statement is incorporated herein by reference.

Item 13. Certain Relationships and Related Transactions, and Director Independence

The information under the caption Information Concerning Directors, Nominees and Executive Officers Independent Directors and Information Concerning Directors, Nominees and Executive Officers Policy and Procedures with Respect to Related Person Transactions to be contained in the 2010 proxy statement is incorporated herein by reference.

Item 14. Principal Accountant Fees and Services

The information under the caption Ratification of Appointment of PricewaterhouseCoopers LLP as Independent Registered Public Accounting Firm to be contained in the 2010 proxy statement is incorporated herein by reference.

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Part IV

Item 15. Exhibits and Financial Statement Schedules

(a) The following Consolidated Financial Statements of Vital Images, Inc. and Report of Independent Registered Public Accounting Firm thereon are included herein:

(1) Financial Statements

(2) All other schedules to the Consolidated Financial Statements required by Article 12 of Regulation S-X are not required under the related instructions or are inapplicable and therefore have been omitted.

(3) Listing of Exhibits

The Exhibits required to be a part of this Report are listed in the Index to Exhibits.

(b) Exhibits

Included in Item 15(a)(3) above.

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Signatures

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized, in Minneapolis, Minnesota, on the 16th day of March, 2010.

Vital Images, Inc.

By: /s/Peter J. Goepfrich
Peter J. Goepfrich
Chief Financial Officer
(Principal Financial Officer and Principal Accounting Officer)

Pursuant to the requirement of the Securities Exchange Act of 1934, this Report has been signed by the following persons in the capacities and on the dates indicated.

Signature	Title	Date
/s/ Michael H. Carrel Michael H. Carrel	President, Chief Executive Officer and Director (Principal Executive Officer)	March 16, 2010
/s/Peter J. Goepfrich Peter J. Goepfrich	Chief Financial Officer and Treasurer (Principal Financial Officer and Principal Accounting Officer)	March 16, 2010
/s/James B. Hickey, Jr. James B. Hickey, Jr.	Chairman of the Board and Director	March 16, 2010
/s/ Oran E. Muduroglu Oran E. Muduroglu	Director	March 16, 2010
/s/ Gregory J. Peet Gregory J. Peet	Director	March 16, 2010
/s/Richard W. Perkins Richard W. Perkins	Director	March 16, 2010
/s/Douglas M. Pihl Douglas M. Pihl	Director	March 16, 2010
/s/Michael W. Vannier Michael W. Vannier	Director	March 16, 2010
/s/Sven A. Wehrwein Sven A. Wehrwein	Director	March 16, 2010

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Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders of Vital Images, Inc.:

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations, of stockholders equity and comprehensive income (loss) and of cash flows present fairly, in all material respects, the financial position of Vital Images, Inc. and its subsidiaries at December 31, 2009 and December 31, 2008, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2009, in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2009, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company s management is responsible for these financial statements, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in Management s Report on Internal Control over Financial Reporting appearing under Item 9A. Our responsibility is to express opinions on these financial statements and on the Company s internal control over financial reporting based on our integrated audits. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ PricewaterhouseCoopers LLP

Minneapolis, Minnesota

March 16, 2010

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Vital Images, Inc.
Consolidated Balance Sheets
(In thousands, except per share amounts)

	December 31, 2009	December 31, 2008
Assets		
Current assets:		
Cash and cash equivalents	$ 120,317	$ 109,706
Marketable securities	9,673	37,287
Accounts receivable, net	12,196	13,047
Deferred income taxes		654
Prepaid expenses and other current assets	2,686	2,179
Total current assets	144,872	162,873
Marketable securities	12,234	
Property and equipment, net	5,485	11,519
Deferred income taxes		13,904
Other intangible assets, net	382	808
Goodwill	9,089	9,089
Total assets	$ 172,062	$ 198,193
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 2,588	$ 3,792
Accrued compensation	3,574	2,936
Accrued royalties	812	1,057
Other current liabilities	1,364	1,947
Deferred revenue	15,500	17,724
Total current liabilities	23,838	27,456
Deferred revenue	1,033	1,164
Deferred rent	469	882
Total liabilities	25,340	29,502
Commitments and contingencies (Note 4)		
Stockholders equity:		
Preferred stock: $0.01 par value; 5,000 shares authorized; none issued or outstanding		
Common stock: $0.01 par value; 40,000 shares authorized; 14,330 issued and outstanding as of December 31, 2009; and 14,673 shares issued and outstanding as of December 31, 2008	143	147
Additional paid-in capital	168,058	168,738
Accumulated deficit	(21,632)	(380)
Accumulated other comprehensive income	153	186
Total stockholders equity	146,722	168,691
Total liabilities and stockholders equity	$ 172,062	$ 198,193

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

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Vital Images, Inc.
Consolidated Statements of Operations
(In thousands, except for per share amounts)

	For the Year Ended December 31,		
	2009	**2008**	**2007**
Revenue:			
License fees	$ 22,766	$ 34,290	$ 39,673
Maintenance and services	33,717	32,436	29,487
Hardware	1,747	1,415	1,016
Total revenue	58,230	68,141	70,176
Cost of revenue:			
License fees	3,301	4,922	4,725
Maintenance and services	9,282	10,089	9,928
Hardware	1,622	862	694
Impairment of patent			242
Total cost of revenue	14,205	15,873	15,589
Gross profit	44,025	52,268	54,587
Operating expenses:			
Sales and marketing	22,579	27,835	29,481
Research and development	16,332	20,355	18,476
General and administrative	9,978	13,243	13,798
Asset impairment (Note 3)	3,147		
Restructuring charge		660	
Total operating expenses	52,036	62,093	61,755
Operating loss	(8,011)	(9,825)	(7,168)
Interest income	1,091	4,643	8,886
(Loss) income before income taxes	(6,920)	(5,182)	1,718
Provision (benefit) for income taxes	14,332	(2,382)	351
Net (loss) income	$ (21,252)	$ (2,800)	$ 1,367
Net (loss) income per share basic	$ (1.48)	$ (0.17)	$ 0.08
Net (loss) income per share diluted	$ (1.48)	$ (0.17)	$ 0.08
Weighted average common shares outstanding - basic	14,315	16,155	16,972
Weighted average common shares outstanding - diluted	14,315	16,155	17,457

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

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Vital Images, Inc.
Consolidated Statements of Stockholders Equity and Comprehensive Income (Loss)

(In thousands)

	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Retained Earnings / (Accumulated Deficit)	Accumulated Other Comprehensive Income / (Loss)	Total Stockholders Equity	Comprehensive Income (Loss)
Balances as of December 31, 2006	16,908	$ 169	$ 189,669	$ 1,053	$ 11	$ 190,902	$ 6,614
Issuance of common stock upon exercise of stock options	221	3	2,352			2,355	
Tax benefit related to exercise of stock options and release of restricted stock			1,443			1,443	
Issuance of common stock under employee stock purchase plan	27		521			521	
Grant of restricted stock to employees	14						
Forfeiture or cancellation of restricted stock	(5)						
Common stock surrendered for payment of payroll tax liability resulting from the vesting of restricted stock	(12)		(347)			(347)	
Stock-based compensation			5,987			5,987	
Change in unrealized gain or loss on investments, net of tax					(8)	(8)	$ (8)
Cumulative translation adjustment					(4)	(4)	(4)
Net income				1,367		1,367	1,367
Balances as of December 31, 2007	17,153	172	199,625	2,420	(1)	202,216	$ 1,355
Issuance of common stock upon exercise of stock options	243	2	1,927			1,929	
Tax benefit related to exercise of stock options and release of restricted stock			50			50	
	43		490			490	

Issuance of common stock under employee stock purchase plan								
Grant of restricted stock to employees	30							
Forfeiture or cancellation of restricted stock	(27)							
Common stock surrendered for payment of payroll tax liability resulting from the vesting of restricted stock	(12)		(174)			(174)		
Stock-based compensation			5,007			5,007		
Repurchases of common stock	(2,757)	(27)	(38,187)			(38,214)		
Change in unrealized gain or loss on investments, net of tax					187	187	$	187
Net loss				(2,800)		(2,800)		(2,800)
Balances as of December 31, 2008	14,673	147	168,738	(380)	186	168,691	$	(2,613)
Issuance of common stock upon exercise of stock options	163	2	1,151			1,153		
Issuance of common stock under employee stock purchase plan	51		496			496		
Grant of restricted stock to employees	15							
Common stock surrendered for payment of payroll tax liability resulting from the vesting of restricted stock	(10)		(119)			(119)		
Stock-based compensation			3,867			3,867		
Repurchases of common stock	(562)	(6)	(6,075)			(6,081)		
Change in unrealized gain or loss on investments, net of tax					(33)	(33)	$	(33)
Net loss				(21,252)		(21,252)		(21,252)
Balances as of December 31, 2009	14,330	$ 143	$ 168,058	$ (21,632)	$ 153	$ 146,722	$	(21,285)

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

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Vital Images, Inc.
Consolidated Statements of Cash Flows

(In thousands)

	For the Year Ended December 31,		
	2009	**2008**	**2007**
Cash flows from operating activities:			
Net (loss) income	$ (21,252)	$ (2,800)	$ 1,367
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization of property and equipment	4,843	4,919	4,517
Amortization of identified intangible assets	426	1,044	1,205
Loss on disposal of assets	111		
Asset impairment	3,147		242
Provision for doubtful accounts	279	519	239
Deferred income taxes	14,664	(2,521)	(16)
Excess tax benefit from stock transactions		(481)	(1,395)
Amortization of discount and accretion of premium on marketable securities	238	(473)	(857)
Employee stock-based compensation	3,867	5,007	5,987
Amortization of deferred rent	(394)	(375)	(338)
Changes in operating assets and liabilities:			
Accounts receivable	572	2,396	3,388
Prepaid expenses and other assets	(507)	262	(513)
Accounts payable	(936)	623	(363)
Accrued expenses and other liabilities	(329)	(740)	(1,142)
Deferred revenue	(2,355)	1,201	1,382
Deferred rent			199
Net cash provided by operating activities	2,374	8,581	13,902
Cash flows from investing activities:			
Purchases of property and equipment	(2,335)	(5,434)	(6,577)
Purchases of marketable securities	(21,749)	(76,395)	(59,974)
Proceeds from maturities of marketable securities	36,752	70,002	49,931
Proceeds from sales of marketable securities		1,581	750
Net cash provided by (used in) investing activities	12,668	(10,246)	(15,870)
Cash flows from financing activities:			
Repurchases of common stock	(6,081)	(38,214)	
Proceeds from sale of common stock under stock plans	1,650	2,419	2,876
Excess tax benefit from stock transactions		481	1,395
Net cash (used in) provided by financing activities	(4,431)	(35,314)	4,271
Net increase (decrease) in cash and cash equivalents	10,611	(36,979)	2,303
Cash and cash equivalents, beginning of period	109,706	146,685	144,382
Cash and cash equivalents, end of period	$ 120,317	$ 109,706	$ 146,685
Supplemental cash flow information:			
Purchases of property and equipment with accounts payable	$ 97	$ 366	$ 525

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

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Vital Images, Inc.
Notes to Consolidated Financial Statements

1. Business description

Vital Images, Inc. (the Company) is a leading provider of advanced visualization and image analysis solutions for use by medical professionals in clinical analysis and therapy planning for medical conditions. The Company provides software, customer education, software maintenance and support, professional services and, on occasion, third-party hardware to its customers. The Company s technology rapidly transforms complex data generated by diagnostic imaging equipment into functional digital images that can be manipulated and analyzed using its specialized applications to better understand internal anatomy and pathology. The Company s solutions are designed to improve physician workflow and productivity, enhance the ability to make clinical decisions, facilitate less invasive patient care, and complement often significant capital investments in diagnostic imaging equipment made by its customers. The Company s software is compatible with equipment from all major manufacturers of diagnostic imaging equipment, such as computed tomography, or CT, scanners, and can be integrated into picture archiving and communication systems, or PACS. Many hospitals use PACS to acquire, distribute and archive medical images and diagnostic reports, reducing the need for film and increasing reliance on advanced visualization solutions such as the Company s. The Company also offers a Web-based solution that provides physicians with anywhere, anytime access to medical images and visualization tools through any Internet-enabled computer.

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

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

Operating expenses for the years ended December 31, 2008 and 2007, as reported and as reclassified were as follows:

	For the Year Ended December 31, 2008		For the Year Ended December 31, 2007	
	As Reported	As Reclassified	As Reported	As Reclassified