

EMAGEON INC  
Form 10-Q  
November 08, 2007

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

**FORM 10-Q**

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

For the quarterly period ended **September 30, 2007**

☐ **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 0-51149**

**EMAGEON INC.**

(Exact name of registrant as specified in its charter)

**Delaware**

**63-1240138**

(State or other jurisdiction of incorporation or  
organization)

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

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

**35242**

(Address of principal executive offices)

(Zip Code)

**(205) 980-9222**

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

☐ Yes ☐ No

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

Large Accelerated Filer ☐ Accelerated Filer ☐ Non-Accelerated Filer ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

☐ Yes ☐ No

Common stock, par value \$0.001 per share: 21,400,734 shares outstanding as of October 25, 2007

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

	(Unaudited) September 30, 2007	December 31, 2006
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents	\$ 17,830	\$ 23,008
Trade accounts receivable, net of allowances of \$270 at September 30, 2007 and \$277 at December 31, 2006	21,325	26,706
Inventories	7,210	8,579
Prepaid expenses and other current assets	5,311	4,459
Total current assets	51,676	62,752
<b>PROPERTY AND EQUIPMENT, net</b>	15,581	18,362
<b>RESTRICTED CASH</b>	1,000	445
<b>OTHER NONCURRENT ASSETS</b>	1,299	1,363
<b>INTANGIBLE ASSETS, net</b>	28,344	30,090
<b>TOTAL ASSETS</b>	\$ 97,900	\$ 113,012
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>CURRENT LIABILITIES:</b>		
Accounts payable	\$ 9,006	\$ 9,738
Accrued payroll and related costs	1,720	3,770
Deferred revenue	16,910	23,953
Other accrued expenses	2,257	2,946
Current portion of long-term debt and capital lease obligations	56	953
Total current liabilities	29,949	41,360
<b>LONG-TERM DEFERRED REVENUE</b>	5,634	5,851
<b>OTHER LONG-TERM LIABILITIES</b>	477	686
<b>LONG-TERM PORTION OF CAPITAL LEASE OBLIGATIONS</b>	63	8
<b>TOTAL LIABILITIES</b>	36,123	47,905
<b>STOCKHOLDERS' EQUITY:</b>		
Common stock, \$0.001 par value, 165,050 shares authorized; 21,574 shares and 21,458 shares issued, and 21,398 shares and 21,282 shares outstanding at September 30, 2007 and December 31, 2006, respectively	22	21
Additional paid-in capital	125,162	122,538
Accumulated other comprehensive income	710	262
Deficit	(63,842)	(57,439)

Treasury stock, 176 shares, at cost	<b>62,052</b> <b>(275)</b>	65,382 (275)
Total stockholders' equity	<b>61,777</b>	65,107
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>	<b>\$ 97,900</b>	<b>\$ 113,012</b>

*The accompanying notes are an integral part of these financial statements.*

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

	Three Months Ended		Unaudited Nine Months Ended	
	September 30,		September 30,	
	2007	2006	2007	2006
<b>REVENUE:</b>				
System sales	\$ 10,706	\$ 19,370	\$ 35,609	\$ 54,240
Support services	12,022	13,641	40,045	35,788
Total revenue	22,728	33,011	75,654	90,028
<b>COST OF REVENUE:</b>				
System sales	6,327	10,712	21,359	33,973
Support services	7,311	6,187	21,365	18,939
Total cost of revenue	13,638	16,899	42,724	52,912
<b>GROSS PROFIT</b>	<b>9,090</b>	16,112	<b>32,930</b>	37,116
<b>OPERATING EXPENSES:</b>				
Research and development	5,567	4,601	15,374	12,763
Sales and marketing	4,121	4,435	13,013	13,026
General and administrative	3,549	4,495	9,968	12,668
Amortization of intangible assets related to Camtronics acquisition	346	885	1,036	2,655
Integration costs related to Camtronics acquisition		2,062		4,343
Restructuring charge			578	
Total operating expenses	13,583	16,478	39,969	45,455
<b>OPERATING LOSS</b>	<b>(4,493)</b>	(366)	<b>(7,039)</b>	(8,339)
<b>INTEREST INCOME</b>	<b>232</b>	157	<b>711</b>	473
<b>INTEREST EXPENSE</b>	<b>(19)</b>	(64)	<b>(75)</b>	(257)
<b>NET LOSS</b>	<b>\$ (4,280)</b>	\$ (273)	<b>\$ (6,403)</b>	\$ (8,123)
<b>NET LOSS PER SHARE BASIC AND DILUTED</b>	<b>\$ (0.20)</b>	\$ (0.01)	<b>\$ (0.30)</b>	\$ (0.39)
<b>WEIGHTED AVERAGE SHARES OUTSTANDING, BASIC AND DILUTED</b>	<b>21,382</b>	21,013	<b>21,342</b>	20,822

*The accompanying notes are an integral part of these financial statements.*

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

	<b>Nine Months Ended September 30,</b>	
	<b>2007</b>	<b>2006</b>
<b>OPERATING ACTIVITIES</b>		
Net loss	\$ (6,403)	\$ (8,123)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation	4,747	5,320
Amortization of intangible assets	2,290	3,677
Stock-based compensation expense	2,091	2,348
Loss on disposal of fixed assets	328	411
Changes in operating assets and liabilities, net	(4,853)	(6,389)
Net cash used in operations	(1,800)	(2,756)
<b>INVESTING ACTIVITIES</b>		
Purchases of property and equipment	(2,225)	(4,330)
Maturities of marketable securities		5,000
Capitalized software development costs	(112)	(551)
Other investing activities	(125)	55
Net cash (used in) provided by investing activities	(2,462)	174
<b>FINANCING ACTIVITIES</b>		
Proceeds of issuance of common stock, net of issue costs	534	2,906
Payment of debt and capital lease obligations	(911)	(2,083)
Increase in restricted cash	(555)	
Net cash (used in) provided by financing activities	(932)	823
<b>EFFECT OF EXCHANGE RATE CHANGES ON CASH</b>	<b>16</b>	<b>1</b>
<b>NET DECREASE IN CASH</b>	<b>(5,178)</b>	<b>(1,758)</b>
<b>CASH at beginning of period</b>	<b>23,008</b>	<b>15,520</b>
<b>CASH at end of period</b>	<b>\$ 17,830</b>	<b>\$ 13,762</b>

*The accompanying notes are an integral part of these financial statements.*

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**EMAGEON INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 1. BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES**

The accompanying unaudited condensed consolidated financial statements include the accounts of Emageon Inc.( Emageon, or the Company ) and its majority-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

In the opinion of management, the accompanying financial statements contain all adjustments (consisting of normal recurring items) necessary for a fair presentation of results for the interim periods presented. These unaudited interim financial statements should be read in conjunction with the audited consolidated financial statements and related notes contained in the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

Certain reclassifications have been made to prior year amounts to provide comparability with the current year presentation. In 2007, the Company revised its presentation of accounts receivable and deferred revenue. Previously, accounts receivable and deferred revenue relating to advance customer billings for services were recorded on a gross basis. This revision reduced both accounts receivable and deferred revenue by \$896 at December 31, 2006. The revision had no effect on the Company's results of operations.

Operating results for the three month and nine month periods ended September 30, 2007 are not necessarily indicative of results that may be expected for the year ending December 31, 2007.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires that management use judgments to make estimates and assumptions that affect the amounts reported in the financial statements. As a result, there is some risk that reported financial results could have been materially different had different methods, assumptions, and estimates been used. The Company believes that of its significant accounting policies, those related to revenue recognition, research and development costs, and intangible and other long-lived assets may involve a higher degree of judgment and complexity than other accounting policies used in the preparation of its consolidated financial statements. There have been no significant changes during the nine months ended September 30, 2007 to the items disclosed as Critical Accounting Policies and Estimates in the Company's Annual Report on Form 10-K for the year ended December 31, 2006 or in the Company's method of application of these critical accounting policies.

All numbers of shares and dollar amounts in the financial statements and footnotes, except per share amounts, are expressed in thousands.

**NOTE 2. RESTRUCTURING CHARGE AND EXIT LIABILITY**

In May 2007, the Company aligned its operating expenses with the current level of revenue by reducing its workforce through elimination of existing positions and normal attrition. In connection with that action, the Company eliminated thirty positions, primarily in the customer service and product management areas. The cost of those position eliminations of \$578, consisting primarily of employee severance pay and related benefits, was included in the Company's statement of operations for the three months ended June 30, 2007. This remaining liability was settled during July, 2007, and the Company does not expect to incur further costs related to its May 2007 reduction in workforce.

During the third quarter of 2006 the Company, as part of the integration of Camtronics Medical Systems Ltd. ( Camtronics ) into the operations of the Company (see Note 3), vacated a leased facility and combined the operations formerly conducted at that facility with those at a location acquired in the Camtronics acquisition. In connection with that action, the Company identified and recorded a liability of \$1,200 arising from the continuing lease obligation, which extends



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through January, 2013, and related expenses. The charge was included in the 2006 statement of operations as a component of Integration Costs Related To Camtronics Acquisition and in current and long-term accrued expenses in the balance sheet. Activity with respect to that liability for the three and nine month periods ended September 30, 2007 is as follows:

	<b>Three Months Ended September 30, 2007</b>	<b>Nine Months Ended September 30, 2007</b>
Beginning liability balance	\$ 852	\$ 1,057
Lease payments	(76)	(251)
Reduction in estimated liability	(116)	(116)
Payment of related expenses, net	(6)	(36)
Ending liability balance	\$ 654	\$ 654

The Company does not expect to incur further expenses related to these integration activities. The reduction in estimated liability was made as a result of the Company's entering into an agreement with a sublessor earlier than anticipated.

**NOTE 3 . ACQUISITIONS AND INTANGIBLE ASSETS**

On November 1, 2005 the Company acquired all of the outstanding capital stock of Camtronics, a developer and manufacturer of cardiology image and information management systems, for a cash purchase price, including acquisition expenses and net of cash acquired, of \$40,359. The results of operations of Camtronics have been included in the Company's statement of operations since the acquisition date.

The purchase price of Camtronics was allocated to the assets and liabilities of Camtronics on a fair-value basis, including the identification and valuation of its intangible assets and the assignment of value to goodwill. Goodwill represents, among other things, the synergistic value and potential competitive benefits that may be realized as a result of the acquisition, any future products that may arise from the acquired technology, and the skilled and specialized workforce acquired. In total, intangible asset value of \$11,603 and goodwill value of \$17,325 related to the Camtronics acquisition was identified and recorded.

Summarized below are the Company's intangible assets, which include those arising from the acquisition of Camtronics and other businesses and the capitalized portion of costs of internally developed software. These assets are amortized on a straight-line basis over lives ranging from one to six years, with the exception of goodwill, which is not amortized but is tested for impairment at least annually or as circumstances arise that may indicate impairment. The Company tested each of its intangible assets for impairment as of September 30, 2007 and found that no such impairment had occurred.

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	<b>September 30, 2007</b>			<b>December 31, 2006</b>		
	<b>Gross Carrying Amount</b>	<b>Total Amortization</b>	<b>Net Carrying Amount</b>	<b>Gross Carrying Amount</b>	<b>Total Amortization</b>	<b>Net Carrying Amount</b>
Acquired technology	\$ 5,240	\$ 4,296	\$ 944	\$ 5,240	\$ 3,404	\$ 1,836
Customer relationships	8,010	2,648	5,362	10,028	3,629	6,399
Trade names				501	501	
Software development costs	1,562	1,166	396	1,451	806	645
Goodwill	21,642		21,642	21,210		21,210
Total	\$ 36,454	\$ 8,110	\$ 28,344	\$ 38,430	\$ 8,340	\$ 30,090

Weighted average amortization periods are 4.6 years for acquired technology, 5.8 years for customer relationships, and 1.3 years for software development costs.

Amortization expense was \$4,969 for the year ended December 31, 2006 and \$2,290 for the nine months ended September 30, 2007. Estimated amortization expense for the remainder of 2007 and beyond is as follows:

Remainder of 2007	\$ 722
2008	2,345
2009	1,381
2010	1,335
2011 and thereafter	919
Total	\$ 6,702

**NOTE 4. INVENTORIES**

Inventories consist of the following:

	<b>September 30, 2007</b>	<b>December 31, 2006</b>
Third-party components	\$ 2,971	\$ 2,716
Work-in-process	401	336
Completed systems	3,838	5,527
Total	\$ 7,210	\$ 8,579

Inventories include the costs of materials, labor, and overhead. The costs of purchased third-party hardware and software associated with customer sales contracts are included as inventory in the consolidated balance sheet and charged to system sales cost of revenue in the statement of operations when customer acceptance has been received and all other revenue recognition criteria have been met.

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Changes in the operating assets and liabilities of the Company in reconciling net loss to net cash provided by or used in operations are as follows:

	<b>Nine Months Ended September 30,</b>	
	<b>2007</b>	<b>2006</b>
(Increase) decrease in:		
Trade accounts receivable, net	\$ 5,381	\$ (533)
Inventories, net	1,369	(1,844)
Prepaid expenses and other current assets	(852)	(722)
Other noncurrent assets	189	(228)
Increase (decrease) in:		
Accounts payable	(732)	(3,911)
Accrued payroll and related costs	(2,050)	(657)
Other accrued expenses	(898)	333
Deferred revenue	(7,260)	1,173
Net changes in operating assets and liabilities	\$ (4,853)	\$ (6,389)

There were no significant non-cash investing and financing transactions in the nine month periods ended September 30, 2007 and 2006.

**NOTE 6. COMPUTATION OF NET LOSS PER SHARE**

Basic and diluted net loss per share is computed using the weighted average common shares outstanding during the period. Common share equivalents consist of common stock warrants, restricted stock awards, and stock options granted to employees and directors. All share equivalents, consisting of 2,366 shares as of September 30, 2007 (1,931 shares as of September 30, 2006) were excluded from the computation for these net loss periods because their inclusion would have been anti-dilutive.

**NOTE 7. STOCK BASED COMPENSATION**

The Company's stock-based compensation plans are administered by the Compensation Committee of the Board of Directors, which selects persons eligible to receive awards and determines the number of shares and/or options subject to each award and the terms, conditions, performance measures, and other provisions of the award. Note 14 of the Company's consolidated financial statements included in its Annual Report on Form 10-K for the year ended December 31, 2006 contains additional information related to these stock-based compensation plans.

The Company used the Black-Scholes option pricing model to estimate the fair value of stock-based awards utilizing the following assumptions for the three month and nine month periods ended September 30, 2007 and 2006.

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	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Dividend yield	0%	0%	0%	0%
Expected volatility	50.0%	70.9%	50.0%	70.9%
Risk-free interest rate	4.59%	5.02%	4.62%	4.87%
Expected life of options, in years	5.0	5.0	5.0	5.0

The assumptions above are based on multiple factors, including historical exercise patterns of employees in relatively homogeneous groups with respect to exercise and post-vesting employment termination behaviors, expected future exercising patterns for these same homogeneous groups, and the volatility of the Company's stock price.

The change made in the Company's assumption for stock price volatility from 70.9% in 2006 to 50.0% in 2007 did not materially affect results of operations for the three month or nine month periods ended September 30, 2007.

The following table presents activity in the Company's stock option and restricted stock unit plans for the periods shown (in thousands, except per share amounts):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Stock options:				
Grants, in shares	325	31	675	501
Weighted average grant date fair value, per share	\$ 4.48	\$ 9.38	\$ 5.16	\$ 10.09
Exercises, in shares	19	154	93	613
Proceeds of exercises	\$ 68	\$ 782	\$ 534	\$ 2,906
Restricted stock units:				
Grants, in shares	4	5	65	83
Weighted average grant date fair value, per share	\$ 9.19	\$ 15.05	\$ 12.27	\$ 16.30
Shares vested in the period	8	8	23	16

Stock-based compensation expense recognized in the statement of operations for the three months ended September 30, 2007 was \$751 (\$982 for the three months ended September 30, 2006), and was \$2,091 for the nine months ended September 30, 2007 (\$2,348 for the nine months ended September 30, 2006). At September 30, 2007 there was \$7,300 of unrecognized compensation cost related to stock-based payments. The Company expects this compensation cost to be recognized over a weighted-average period of 2.91 years.

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**NOTE 8. COMPREHENSIVE LOSS**

The Company's comprehensive loss differs from its reported net loss due to foreign currency translation adjustments. Comprehensive loss for the three months ended September 30, 2007 was \$4,087 (\$274 for the three months ended September 30, 2006), and for the nine months ended September 30, 2007 was \$5,955 (\$7,792 for the nine months ended September 30, 2006). Net accumulated other comprehensive income adjustments as of September 30, 2007 were \$710.

**NOTE 9. INCOME TAXES**

In July 2006, the Financial Accounting Standards Board ( FASB ) issued FASB Interpretation No. 48, *Accounting For Uncertainty In Income Taxes* ( FIN 48 ). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with Statement of Financial Accounting Standards No. 109, *Accounting For Income Taxes*. FIN 48 requires recognition in the financial statements of only those tax positions determined to be more likely than not of being sustained upon examination based on the technical merits of the positions, and also provides guidance on derecognition, classification, interest and penalties, interim period accounting, disclosure, and transition. The Company adopted the provisions of FIN 48 effective January 1, 2007. The Company has not had taxable income since incorporation and therefore has not paid any income taxes or recognized any tax benefit or tax expense in its statements of operations. At January 1, 2007, the Company had net deferred tax assets of \$21.8 million, the majority of which relates to the tax benefit of net operating loss carryforwards that will be realized only if the Company is profitable in future years. Because future profitability is uncertain, the Company has provided a valuation allowance against its net deferred tax assets, including its net operating loss carryforwards, in full. The valuation allowance will remain at the full amount until it is more likely than not that the related tax benefits will be realized through deduction against taxable income during the carryforward periods, which extend from 2019 through 2026. Given its lack of historical taxable income and the full amount of the deferred tax asset valuation allowance, adoption of FIN 48 has had no effect on the Company's statement of operations for the nine months ended September 30, 2007 or on the balance of its accumulated deficit as of the January 1, 2007 date of adoption.

The Company files income tax returns in the United States and Canada federal jurisdictions and in various state jurisdictions. The Company's federal income tax returns have never been examined, and all years since the Company's incorporation in 1998 remain subject to federal and state tax examinations. The Company believes that any adjustments resulting from tax examinations would have an immaterial effect on its results of operations and financial position.

As of January 1, 2007, the gross amount of unrecognized tax benefits and the total amount of unrecognized tax benefits that, if recognized, would affect the Company's financial statement effective rate of tax, were zero.

The Company has not recognized significant interest or penalties related to unrecognized tax benefits.

**NOTE 10. WARRANTY OBLIGATION**

The Company provides for the estimated costs of product warranties at the time revenue is recognized if the customer does not purchase a service contract. Its warranty obligations depend upon product failure rates and service delivery costs incurred to correct any product failures. The Company's estimates of warranty obligation are based on specific warranty claims, historical data, and engineering estimates. If actual product failure rates or service delivery costs differ from estimates, the estimated warranty liability is revised.

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The Company warrants that its software products will perform in all material respects in accordance with standard published specifications in effect at the time of delivery of the licensed products as long as the warranty remains in effect, and warrants that its services will be performed by qualified personnel in a manner consistent with normally accepted industry standards.

Activity in the Company's warranty liability for the three and nine month periods ended September 30, 2007 is as follows:

	<b>Three Months Ended September 30, 2007</b>	<b>Nine Months Ended September 30, 2007</b>
Beginning liability balance	\$ 535	\$ 700
Additions charged to expense	82	423
Deductions for claim resolution	(155)	(661)
Ending liability balance	\$ 462	\$ 462

## **ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

### **FORWARD-LOOKING STATEMENTS**

Some of the statements made in this Quarterly Report on Form 10-Q contain forward-looking statements which reflect the Company's plans, beliefs, and current views with respect to, among other things, future events and financial performance. These statements are often identified by use of forward-looking words such as "believe", "expect", "potential", "continue", "may", "will", "should", "could", "would", "intend", "plan", "estimate", "anticipate", and comparable words or version of these and other words. Any forward-looking statement contained in this Form 10-Q is based upon the Company's historical performance and on current plans, estimates, and expectations. The inclusion of this forward-looking information should not be regarded as a representation by the Company or any other person that the future plans, estimates, or expectations contemplated by the Company will be achieved. Such forward-looking statements are subject to various risks and uncertainties. In addition, there are or will be important factors that could cause actual results to differ materially from those indicated in the statements. These factors include, but are not limited to, those described in Item 1A of the Company's Annual Report on Form 10-K for the year ended December 31, 2006 under the caption "Risk Factors".

This cautionary statement should not be regarded as exhaustive and should be read in conjunction with other cautionary statements and other information contained in the Company's Annual Report on Form 10-K for the year ended December 31, 2006. The Company operates in a continually changing business environment, and new risks and uncertainties emerge from time to time. Management cannot predict these new risks and uncertainties, nor can it assess the impact, if any, that any such risks and uncertainties may have on the Company's business or the extent to which any factor or combination of factors may cause actual results to differ from those projected in any forward-looking statement. Accordingly, the risks and uncertainties to which the Company is subject can be expected to change over time, and the Company undertakes no obligation to update publicly or review the risks or uncertainties described herein or in the Company's Annual Report on Form 10-K for the year ended December 31, 2006. The Company also undertakes no obligation to update publicly or review any of the forward-looking statements made in this Form 10-Q, whether as a result of new information, future developments, or otherwise.

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This Management's Discussion and Analysis of Financial Condition and Results of Operations section should be read in conjunction with the unaudited financial statements and footnotes appearing in Part I of this Form 10-Q and the audited financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

### **COMPANY OVERVIEW**

Emageon provides an enterprise-level information technology solution for the clinical analysis and management of digital medical images within multi-hospital networks, community hospitals, and diagnostic imaging centers. The Company's solution consists of advanced visualization and image management software, third-party components, and comprehensive support services. The Company's web-enabled advanced visualization software, which is hosted by the customer, provides physicians across the enterprise, in multiple medical specialties and at any network access point, with dynamic tools to manipulate and analyze images in both a two dimensional and three dimensional perspective. With these tools, physicians have the ability to better understand internal anatomic structure and pathology, which can improve clinical diagnoses, disease screening, and therapy planning. The Company's open standard solution is designed to help customers improve staff productivity, enhance revenue opportunities, automate complex medical imaging workflow, lower total cost of ownership, and provide better service to physicians and patients.

### **RESULTS SUMMARY**

The medical imaging industry and the Company's 2007 revenues have been adversely affected by slower market demand for medical imaging software, hardware, and support services relative to prior periods. In addition, the Company's primary radiology market has become largely a replacement market with longer sales cycles. Revenue for the three months ended September 30, 2007 (the Company's third fiscal quarter of 2007) was \$22.7 million, a 31.2% decrease from the third quarter of 2006. For the nine months ended September 30, 2007, total revenue was \$75.7 million, a 16.0% decrease from the comparable prior year period. The net loss for the third quarter of 2007 was \$4.3 million, or \$0.20 per share, compared to a net loss of \$0.3 million, or \$0.01 per share, in the third quarter of 2006. For the nine months ended September 30, 2007, the Company's net loss was \$6.4 million, or \$0.30 per share, compared to a net loss of \$8.1 million, or \$0.39 per share, in the first nine months of 2006.

The Company's third quarter operating loss increased from \$0.4 million in 2006 to \$4.5 million in 2007, the result primarily of the negative effects of a \$10.3 million decline in revenue and an 8.8 percentage point decline in gross margin, offset by a decline in sales and marketing and general and administrative expenses and by the elimination of expenses incurred in the integration of Camtronics into the operations of the Company. Excluding the nonrecurring expenses of that integration included in third quarter 2006 operations, the Company's operating loss increased by \$6.2 million in third quarter 2007 compared to third quarter 2006.

The Company's operating loss for the nine months ended September 30, 2007 improved from \$8.3 million in 2006 to \$7.0 million in 2007, the result primarily of a gross margin improvement of 2.3 percentage points and the elimination of expenses incurred in the integration of Camtronics into the operations of the Company, offset by a decline in revenue in the period of \$14.4 million. Excluding the effects of nonrecurring expenses of that integration included in 2006 results of operations, and excluding the Company's second quarter 2007 restructuring charge for employee terminations, the Company's operating loss increased by \$2.5 million in the nine months ended September 30, 2007 compared to the nine months ended September 30, 2006.

Net cash used in operations in the third quarter of 2007 was \$1.5 million, and for the nine months ended September 30, 2007 was \$1.8 million. At September 30, 2007 the Company had approximately \$17.8 million in unrestricted cash and cash equivalents, a decline of \$5.2 million from the December 31, 2006 level.

### **Revenue and Gross Margin**

Revenue consists of system sales and support services revenue. System sales revenue is comprised of revenue from sales of the Company's software and third-party components, primarily computer hardware. Costs of system sales revenue consist of purchases of hardware and software from third party vendors for use by customers and

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the internal costs of the Company's software licenses. Software development expenses are generally included in research and development expense in the Company's statement of operations.

Support services revenue is comprised of revenue from professional services such as implementation and training, as well as ongoing maintenance services. Costs of support services revenue consist of labor, overhead, and associated costs of implementation, installation, and training on behalf of customers, and the costs of providing continuous support of hardware and software sold to customers.

The characteristics of individual system sales can vary significantly as to length of implementation time, total value of the sale, and gross margin earned. In addition, in any given period, the mix of system sales revenue to support services revenue and the mix of hardware and software comprising system sales revenue can produce significant variability in the levels of revenue and total gross margin reported.

The following table sets forth comparative revenue and gross margin data for the three and nine month periods ended September 30, 2007 and 2006.

	(In Thousands)			
	Three Months Ended Sept. 30,		Nine Months Ended Sept. 30,	
	2007	2006	2007	2006
Revenue:				
System sales	\$ 10,706	\$ 19,370	\$ 35,609	\$ 54,240
Support services	12,022	13,641	40,045	35,788
Total	\$ 22,728	\$ 33,011	\$ 75,654	\$ 90,028
Cost of Revenue:				
System sales	\$ 6,327	\$ 10,712	\$ 21,359	\$ 33,973
Support services	7,311	6,187	21,365	18,939
Total	\$ 13,638	\$ 16,899	\$ 42,724	\$ 52,912
Gross Profit:				
System sales	\$ 4,379	\$ 8,658	\$ 14,250	\$ 20,267
Support services	4,711	7,454	18,680	16,849
Total	\$ 9,090	\$ 16,112	\$ 32,930	\$ 37,116
Gross Margin:				
System sales	40.9%	44.7%	40.0%	37.4%
Support services	39.2%	54.6%	46.6%	47.1%
Total	40.0%	48.8%	43.5%	41.2%

***Summary***

Total revenue in third quarter 2007 was \$22.7 million, a 31.2% decrease from third quarter 2006. For the nine months ended September 30, 2007, total revenue was \$75.7 million, a 16.0% decrease from the comparable prior year period. These declines in revenue reflect soft system sales bookings experienced by the Company and in the industry in general, beginning in late fourth quarter 2006 and extending through 2007. Third quarter 2007 gross margin on total revenue declined compared to the prior year period by 8.8 percentage points, and improved by 2.3 percentage points in the nine months ended September 30, 2007 compared to the prior year period. The two components of the Company's revenue and gross margin are discussed individually below in comparison to the prior year periods.

Sequentially, third quarter 2007 total revenues decreased by \$2.8 million from the second quarter of 2007.



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### *System Sales Revenue*

Third quarter 2007 system sales revenue declined by \$8.7 million, or 44.7%, compared to the third quarter of 2006. For the nine months ended September 30, 2007, system sales revenue was \$35.6 million, or 34.3% less than in the first nine months of 2006. The most significant factors contributing to both the third quarter and year to date declines in revenue are general weakness in demand across the Company's primary markets, an increasingly longer sales cycle in the Company's primary radiology market, which is now largely a replacement market among the Company's traditional larger-sized existing and potential customers, and delays in the award of several specific sales contracts from customers.

Third quarter 2007 system sales revenue includes approximately \$1.2 million of software revenue resulting from an amendment to an existing customer agreement executed in third quarter 2007. This revenue, which had previously been deferred by the Company, related to completed implementations of the Company's systems at several of that customer's sites. The original customer agreement included a refund clause that resulted in a requirement for accounting purposes to defer the revenue and recognize it over a five to eight year period. The amendment to the agreement deleted the refund clause and added a liquidated damages cap of \$1.0 million that would be activated in the event of discontinuance of the Company's support of the software purchased by the customer. Pursuant to the terms of the amended contract, the Company has segregated \$1.0 million of its cash representing the amount of potential liquidated damages under the amendment, has classified that cash as a non-current asset in the balance sheet, and has deferred \$1.0 million in associated revenue pending expiration of the liquidated damages provisions of the amendment.

The percentage of total system sales revenue represented by software sales was lower in third quarter 2007 than in third quarter 2006. On a year to date 2007 basis, the percentage of total systems sales revenue represented by software was higher than in the comparable period in 2006, due in large part to two individually significant software-only sales in 2007 and to individually significant hardware sales in the first half of 2006 that increased that period's system sales hardware content.

In an effort to broaden its potential markets, the Company acted in third quarter 2007 to introduce its products to the medium-to smaller-sized hospital market, but does not anticipate significant penetration of this market until 2008.

### *System Sales Gross Margin*

The Company's system sales gross margin was 40.9% for third quarter 2007 compared to 44.7% in third quarter 2006. Third quarter 2007 margin was lower than expected, in large part because of lower sales bookings activity in earlier quarters that resulted in a lower volume of system installations in the third quarter, and because of the lower percentage of software revenue to total system sales revenue for the period as described above.

For the nine months ended September 30, 2007, system sales gross margin was 40.0% compared to 37.4% for the same period in 2006. Current year to date gross margin was lowered by lower volume, offset by a higher mix of software systems revenue to total system sales revenue, as described above. System sales gross margin for the first nine months of 2006 was adversely affected by first half 2006 system sales revenue characterized by a high hardware content in the systems sold.

In general, the costs of third party hardware components tend to lower the Company's system sales gross margin. The Company's system sales gross margin may significantly fluctuate from period to period depending on the mix of revenue recognized in a given reporting period, hardware versus software content of sales recognized, and the timing of completion of installation and customer acceptance of larger dollar individual sales.

### *Support Services Revenue*

The Company's support services revenue declined by \$1.6 million, or 11.9%, in third quarter 2007 compared to the prior year period, and increased by \$4.3 million, or 11.9%, for the nine months ended September 30, 2007 compared to the same period in 2006. Support services revenue, which consists primarily of system installation

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services, customer training, professional services, and system maintenance services, is ancillary to the Company's system sales revenue and therefore fluctuates with both the level of system sales revenue and its timing on a period to period basis. Sequentially, support services revenue was \$2.3 million, or 16.2%, lower in third quarter 2007 than in second quarter 2007 as the result of a lower volume of system installations and related fees during the third quarter of 2007.

*Support Services Gross Margin*

The Company's support services gross margin was 39.2% in third quarter 2007, a 15.4 percentage point decrease from the third quarter 2006 level, and was 46.6% for the nine months ended September 30, 2007, approximately equal to the comparable prior year period. Support services gross margin in 2006 did not include the costs of support personnel who at that time were performing duties of an administrative nature. In 2007, those personnel no longer perform administrative functions and their cost is therefore included in support services cost of revenue, lowering 2007 gross margin. Support services gross margin has been further lowered by a lower volume of system installations, resulting in lower revenue relative to the generally fixed costs of support personnel. Offsetting these negative factors is the positive impact of the Company's elimination of support positions and restructuring in May 2007. The Company believes that its support services gross margin will fluctuate from period to period as the fixed costs of support personnel are spread over support revenues that fluctuate with the level of system sales revenue.

Going forward, the Company expects a normalized support services gross margin in the mid- to high forty percent range assuming growth in support services revenue and efficiencies in its management of support staff, but also expects some timing-based variability in support services gross margin from period to period as the result of timing of closure of individual services contracts.

**Research & Development, Sales & Marketing, and General & Administrative Expenses**

Total research and development, sales and marketing, and general and administrative expenses for the quarter ended September 30, 2007 were \$13.2 million compared to \$13.5 million in the corresponding prior year period, a decrease of \$0.3 million or 2.2%. This net decline was the result primarily of an increase in research and development expenses resulting from increased utilization and costs of outsourced services, offset by a decrease in general and administrative expenses resulting from a decline in the administrative duties of support services personnel. As a percentage of revenue, these expenses were 58.2% in third quarter 2007 compared to 41.0% in third quarter 2006.

For the nine months ended September 30, 2007, total research and development, sales and marketing, and general and administrative expenses were \$38.4 million, down \$0.1 million from the comparable prior year period, the result primarily of a decline in general and administrative expenses, offset by significantly increased research and development expenses, both for the reasons described above. As a percentage of revenue, these expenses were 50.7% in the nine months ended September 30, 2007 compared to 42.7% in the comparable prior year period.

The Company continues to seek to identify opportunities to reduce or limit the growth of its operating expenses in an effort to better align these expenses with the expected level of revenue growth.

*Research and Development Expenses*

Research and development expenses increased by \$1.0 million, or 21.0 %, in third quarter 2007 compared to third quarter 2006. The increase is the result of higher utilization and higher costs of outsourced research and development and related services and expenses in 2007, offset by reduced engineering salary and related costs resulting from the Company's lowering of engineering headcount in May 2007. As a percentage of revenue, research and development expenses were 24.5% in third quarter 2007 compared to 13.9% in third quarter 2006.

For the nine months ended September 30, 2007, research and development expenses increased by \$2.6 million, or 20.5%, over the prior year period for the same reasons as described for third quarter 2007 above. As a percentage of revenue, research and development expenses were 20.3% in the first nine months of 2007 compared to 14.2% in the first nine months of 2006.

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### *Sales and Marketing Expenses*

Sales and marketing expense in the third quarter of 2007 was \$4.1 million, down \$0.3 million from third quarter 2006. Of the primary items comprising sales and marketing expense, salaries and benefits, including sales commissions, were flat to down compared to the prior year period, as were travel and related expenses. The level of commission expense recognized in a given period is affected by the timing of receipt of sales order bookings and revenue recognition. As a percentage of revenue, sales and marketing expenses were 18.1% in third quarter 2007 compared to 13.4% in third quarter 2006.

Sales and marketing expenses in the nine months ended September 30, 2007 were flat with the comparable prior year period at \$13.0 million. Salaries and benefits were flat, while travel was slightly down and overhead expenses slightly up period to period. As a percentage of revenue, sales and marketing expenses were 17.2% in the first nine months of 2007 compared to 14.5% in the first nine months of 2006.

### *General and Administrative Expenses*

General and administrative expenses decreased by \$0.9 million, or 21.0%, in third quarter 2007 compared to third quarter 2006. In 2006, a portion of support services personnel were temporarily engaged in activities of an administrative nature, and accordingly their cost was charged to general and administrative expense. These personnel no longer perform administrative duties and therefore these costs are no longer included in general and administrative expenses. In addition, the Company's incentive bonus expense was less in third quarter 2007 than in third quarter 2006 as a result of the financial performance of the Company through third quarter compared to its financial goals for the year. As a percentage of revenue, general and administrative expenses were 15.6% in the third quarter of 2007 compared to 13.6% in the third quarter of 2006.

For the nine months ended September 30, 2007, general and administrative expenses decreased by \$2.7 million, or 21.3%, over the prior year period. The decline in expenses related to the duties of customer support personnel and the decline in incentive bonus expense, both as explained for the third quarter above, are primarily responsible for the year to date decline. As a percentage of revenue, general and administrative expenses were 13.2% in the first nine months of 2007 compared to 14.1% in the first nine months of 2006.

## **LIQUIDITY AND CAPITAL RESOURCES**

### **Summary**

The Company's unrestricted cash and cash equivalents at September 30, 2007 totaled \$17.8 million, a decline of approximately \$5.2 million since December 31, 2006. This decline is primarily the result of funding of the Company's net loss for the first nine months of 2007, but also includes the effects of investment in property, plant, and equipment of \$2.2 million and the payment of scheduled debt installments of \$0.9 million, offset by the proceeds of stock option exercises by employees of \$0.5 million. Net cash used in operating activities in the third quarter of 2007 was \$1.5 million compared to a consumption of cash in operations of \$0.1 million in third quarter 2006 and a net positive contribution from operations of \$3.7 million in the second quarter of 2007. Total debt remained minimal, and the Company has not drawn on its \$15 million line of credit arrangement with a bank. The Company continues to believe that its existing cash balances, together with its future cash flows and the availability of funding under its line of credit, if necessary, will be sufficient to fund its operations for the next twelve months.

### **Cash Used In Operating Activities**

Net cash used in operations for the nine months ended September 30, 2007 was \$1.8 million compared to a net usage of cash of \$2.8 million in the nine months ended September 30, 2006. The net use of cash in the first nine months of 2007 is essentially the result of the Company's net loss for the period, but also includes the negative effects of timing and activity level-based fluctuations in accounts payable and accrued liabilities and a decline in deferred revenue related to weak sales orders in 2007 as compared to 2006.

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The net use of cash of \$2.8 million in the nine months ended September 30, 2006 was the result primarily of that period's net loss of \$8.1 million, but also included the negative effects of an inventory increase of \$1.8 million and a net accounts payable and accrued liability decline of \$4.2 million, both largely timing in nature.

Cash from operating activities in a given period is most affected by the Company's net income or loss for the period, by the timing of billings to customers versus the timing of revenue recognition, and by the timing of receipt and delivery of sales orders, which can temporarily affect the levels of inventory and accounts payable. The Company is closely monitoring its cash position in view of the decline in sales order activity in 2007.

### **Cash From Investing Activities**

Net cash used in investing activities was \$2.5 million in the first nine months of 2007 compared to a net provision of cash from investing activities of \$0.2 million in the comparable prior year period. The first nine months 2007 use of cash included \$2.2 million in capital expenditures, primarily related to the acquisition of computer equipment.

The net provision of cash by investing activities of \$0.2 million in the nine months ended September 30, 2006 consisted primarily of the maturity of \$5.0 million of marketable securities, the proceeds of which were used to finance operating activities, and a use of cash of \$4.3 million to purchase property and equipment items for internal use, primarily in research and development and to equip new employees.

The level of the Company's purchases of property and equipment for internal use and for use at customer sites is dependent primarily on growth in its customer base, employee headcount, and research and development activities.

### **Cash From Financing Activities**

Net cash used in financing activities was \$0.9 million in the nine months ended September 30, 2007 compared to a provision of cash from financing activities in the first nine months of 2006 of \$0.8 million. Year to date September 30, 2007 financing activities included payment of scheduled debt of \$0.9 million and an increase in long-term restricted cash of \$0.6 million, offset by proceeds of employees' exercises of stock options of \$0.5 million.

The net provision of cash from financing activities of \$0.8 million in the nine months ended September 30, 2006 consisted of proceeds of \$2.9 million on the exercise of stock options, offset by regularly scheduled payments of outstanding debt of \$2.1 million.

### **Contractual Cash Obligations**

As of September 30, 2007 the Company had total obligations for the payment of cash of approximately \$5.5 million, consisting of \$0.1 million in debt and capital lease obligations and \$5.4 million in operating lease commitments, primarily for office space. Under their present terms, these obligations come due in the amounts of approximately \$1.6 million in less than one year, \$2.6 million in one to three years, and \$1.3 million in three years and beyond.

### **Available Credit**

In August 2007, the Company amended its existing credit agreement with a bank to increase the amount of credit available to \$15 million. Credit available under the agreement had previously been \$10 million. Interest on any borrowings under the agreement is at the bank's prime rate. The agreement is for a term of two years, at the end of which all amounts become due and payable. Security for any amounts borrowed under the agreement consists of all assets of the Company other than its intellectual property and real estate. At September 30, 2007 there were no amounts outstanding under the agreement.

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The Company believes that existing cash, together with its future cash flows and amounts available under its loan and security agreement, if necessary, will be sufficient to execute its business plan for the next twelve months. However, any projections of cash flow are subject to uncertainties, including the Company's rate of revenue growth, the expansion of its sales and marketing activities, the timing and extent of spending in support of product development efforts, the timing and success of new product introductions, market acceptance of the Company's products, and costs and risks associated with the integration of acquired businesses. In addition, although not currently a party to any binding letter of intent or agreement, the Company may also invest in or acquire complementary businesses, services, or technologies, which could require that funding be obtained through additional equity or debt financing. It is possible that additional financing for any of these purposes could be required, and that additional funds may not be available on favorable terms or at all.

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

The debt instruments of the Company do not expose the Company to material market risks relating to changes in interest rates.

Excess funds of the Company are invested in short-term, interest-bearing, investment-grade securities. The value of these securities is subject to interest rate risk and could decline in value if interest rates rise. The effect of a hypothetical one hundred basis point decrease across all interest rates related to the Company's investments would result in an annual decrease of approximately \$0.1 million in operating results, assuming no change in the amount of investments on hand at September 30, 2007.

**ITEM 4. CONTROLS AND PROCEDURES**

The Company maintains disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) promulgated under the Securities Exchange Act of 1934, as amended, that are designed to ensure that information required to be disclosed in the reports filed or submitted by the Company under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms and that such information is accumulated and communicated to management of the Company, including its Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. Charles A. Jett, Jr., Chief Executive Officer and President, and W. Randall Pittman, Chief Financial Officer and Treasurer, conducted an evaluation of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of September 30, 2007 and, based on that evaluation, found the Company's disclosure controls and procedures were effective in ensuring that information required to be disclosed in the reports filed by the Company and submitted under the Exchange Act is recorded, processed, summarized and reported as and when required, and that information required to be disclosed is accumulated and communicated to them as appropriate to allow timely decisions regarding timely disclosure. There have been no changes in the Company's internal controls over financial reporting during the nine months ended September 30, 2007 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**Table of Contents****PART II. OTHER INFORMATION****ITEM 1A. RISK FACTORS**

In addition to the other information set forth in this report, careful consideration should be given to the factors discussed in Part I, Item 1A. Risk Factors in the Company's Annual Report on Form 10-K for the year ended December 31, 2006, which could materially affect the Company's business, financial condition, or future results. The risks described in the Company's Annual Report on Form 10-K are not the only risks facing the Company. Additional risks and uncertainties not currently known or that are currently deemed to be immaterial also may materially adversely affect the Company's business, financial condition, and/or operating results.

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

The Company's initial public offering of its common stock was effected through a Registration Statement on Form S-1 which was declared effective on February 8, 2005. In the offering the Company sold 5,750,000 shares of common stock for net proceeds of approximately \$67.2 million. On February 18, 2005 the Company used \$4.0 million of the proceeds to repay borrowings under its subordinated notes, and invested the remaining proceeds in short-term, investment grade securities pending further use. Since that time and through September 30, 2007, the Company has used approximately \$12.8 million of the net proceeds for capital purchases, substantially all of which have been equipment, and an additional \$40.0 million of the net proceeds to acquire all of the outstanding stock of Camtronics Medical Systems, Ltd. on November 1, 2005.

**ITEM 6. EXHIBITS**

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

\* Filed herewith

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**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, Emageon Inc. has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized November 8, 2007.

**EMAGEON INC.**

By: /s/ Charles A. Jett. Jr.  
Charles A. Jett, Jr.  
Chairman, Chief Executive Officer, and  
President (Principal Executive Officer)

By: /s/ W. Randall Pittman  
W. Randall Pittman  
Chief Financial Officer and Treasurer  
(Principal Financial Officer)

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