MERGE HEALTHCARE INC
Form 10-K
March 14, 2014

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, 2013

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 001-33006

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

Delaware	39-1600938
(State or other jurisdiction of incorporation or organization)	(I. R. S. Employer Identification No.)

350 North Orleans Street, 1st Floor
Chicago, Illinois 60654
(Address of principal executive offices, including zip code)
(Registrant's telephone number, including area code) (312) 565-6868
Securities registered under Section 12(b) of the Exchange Act:

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock, $0.01 par value per share	The NASDAQ Global Select Market

Securities registered under Section 12(g) of the Exchange 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 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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x 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. x

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or 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 Smaller reporting company o

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

The aggregate market value for the Registrant's voting and non-voting common equity held by non-affiliates of the Registrant as of June 30, 2013, based upon the closing sale price of the Common Stock on June 30, 2013, as reported on The NASDAQ Global Select Market, was approximately $239,197,597. Shares of Common Stock held by each officer and director and by each person who owns ten percent or more of the outstanding Common Stock have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

The number of shares outstanding of the Registrant's common stock, par value $0.01 per share, as of March 3, 2014: 97,115,148

DOCUMENTS INCORPORATED BY REFERENCE

Certain of the information required by Part III is incorporated by reference from the Registrant's Proxy Statement for its 2014 Annual Meeting of Shareholders.

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PART I

This Annual Report on Form 10 K and 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." 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 affirmat 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 and we cannot guarantee future results, levels of activity, and/or performance. 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, the risks and other matters set forth in the section entitled "Item 1A Risk Factors" in this Annual Report on Form 10-K. 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 business and 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

Overview

Merge Healthcare develops enterprise imaging software solutions that facilitate the management of images to create a more effective and efficient electronic healthcare experience for patients and physicians. Our solutions are designed to help solve some of the most difficult challenges in health information exchange today, such as the incorporation of medical images and diagnostic information into broader healthcare IT applications, the interoperability of proprietary software solutions, and the ability to improve the efficiency and cost effectiveness of our customers' businesses. Our ability to innovate has driven consistent expansion of solutions and services and entry into new markets.

We are a Delaware corporation that was founded in 1987. Our principal executive offices are located at 350 North Orleans Street, 1st Floor, Chicago, Illinois, 60654, and our telephone number there is (312) 565-6868.

Our website address, which we use to communicate important business information, can be accessed at: www.merge.com. We make our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and all amendments to those reports available free of charge on or through our website as soon as reasonably practicable after such material is electronically filed with or furnished to the Securities and Exchange Commission (SEC). Materials we file with or furnish to the SEC may also be read and copied at the SEC's Public reference Room at 100 F Street, NE, Washington, D.C. 20549. Information on the operation of the Public Reference Room may be obtained by calling the SEC at 1-800-SEC-0330. Also, the SEC Internet site (www.sec.gov) contains reports, proxy and information statements, and other information that we file electronically with the SEC.

Our solutions optimize processes for healthcare providers ranging in size from single provider practices to large health systems, to the sponsors of clinical trials and medical device manufacturers. These solutions are licensed by more than 1,500 hospitals, 6,000 clinics and labs, 250 medical device manufacturers and by top pharmaceutical companies world-wide. We believe that we have an opportunity to grow revenue by expanding our solution footprint with existing customers, as only a small percent currently have more than one of our enterprise solutions.

We operate under two reportable segments: Merge Healthcare and Merge DNA. Merge Healthcare represents approximately 83% of our total revenue and markets, sells and implements interoperability, imaging and clinical solutions to healthcare providers. Merge Healthcare primarily generates revenue from the sale of software (including upgrades), hardware, professional services, maintenance and electronic data interchange (EDI) services. Today, the majority of total revenue is generated through perpetual license agreements with our customers. Merge DNA (Data and Analytics) represents the remaining revenue and focuses on data capture software for clinical trials and other solutions. Merge DNA derives the vast majority of its revenue from software, hardware, professional services and hosting through subscription arrangements.

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Under perpetual license agreements, the software, hardware and professional services are considered to be sources of non-recurring revenue and related backlog. The backlog of non-recurring revenue was approximately $24.2 million and $31.2 million as of December 31, 2013 and 2012, respectively. We also generate revenue through subscription-based pricing arrangements in which the contract elements are payable by our customers over a number of years. Generally, these contracts will include a minimum image volume and/or dollar commitment. As such, revenue from these transactions is recognized ratably over an extended period of time. Subscription arrangements include, but are not limited to, contracts structured with monthly payments (including leases), long-term clinical trials and renewable annual software contracts (with very high renewal rates). Subscription revenue backlog was $55.8 million and $39.8 million as of December 31, 2013 and 2012, respectively. As backlog represents the remaining minimum contracted amounts to be recognized in future periods, the timing and amount to be recognized are subject to a number of factors, including customer readiness, contract termination provisions and agreed upon amendments, to name a few. Due to the variability in timing and length of maintenance renewals, we do not track backlog for maintenance and EDI.

Healthcare IT Industry

We believe there are several factors that may be favorable for the healthcare IT industry over the next few years, most notably the expected rate of growth in healthcare spending. The Centers for Medicare and Medicaid Services (CMS) estimates U.S. healthcare spending in 2013 at $2.9 trillion, or 18.0% of Gross Domestic Product (GDP), and projects it to be 19.9% of GDP by 2022.

The American Recovery and Reinvestment Act (ARRA) and accompanying Health Information Technology for Economic and Clinical Health (HITECH) provisions included more than $35 billion in incentives which reward providers who use certified electronic health records (EHRs) in a meaningful way. These incentives should contribute to increased demand for a broader segment of healthcare IT solutions and services in the United States.

As providers adopt EHRs, we believe the need for solutions such as our iConnect platform, which offers connectivity, access to medical images and interoperability between providers and other healthcare constituents should be significant. Imaging is an essential component of healthcare delivery across the continuum of care.

We believe that we are positioned to provide value added solutions and services to our customers amidst potential changes in industry standards and regulations. We believe the fundamental value proposition of healthcare IT remains strong and that the industry will likely benefit as healthcare providers and governments continue to recognize that these solutions and services contribute to safer, more efficient healthcare delivery.

Merge Growth Strategy

Our strategy is to be a leading provider of enterprise imaging and interoperability solutions and services that improve the exchange of healthcare information. We believe the growth drivers for Merge are the importance of imaging and the need for interoperability.

One of our core strengths is our ability to innovate, which has driven consistent expansion of our solutions and services and our entry into new markets. Our portfolio of technologies is used across a wide variety of clinical specialties in addition to being an increasingly important component of clinical trials. For example, our iConnect platform offers hospitals, imaging centers and Health Information Exchanges (HIEs) the ability to create information exchanges within their environment and with other entities. As providers adopt electronic health records, we believe that the need for solutions offering connectivity and interoperability between providers and other healthcare constituents will be a new opportunity and one for which Merge is well-positioned to compete.

We have an opportunity to cross-sell products to existing customers as only a small percent currently have more than one of our enterprise solutions. This is evidenced by the fact that no customer accounted for more than 5% of our net sales in any of the last three years. With the benefit of a broad customer base and several product lines undergoing ongoing innovation, we intend to continue to leverage technologies into new segments where customers see value.

Our Product Portfolio

We provide a broad range of products and services to our customers, including:

- Image Interoperability Platform
  - iConnect Enterprise Archive; iConnect Access Enterprise Viewer: This interoperability and connectivity platform enables hospitals, imaging centers, Integrated Delivery Networks and HIEs to create image archives and exchanges within their environments and with other entities. This platform provides access to imaging and diagnostic data across disparate sites, geographies, specialties and providers. This solution enables providers to expedite care, reduce duplicate exams, consolidate infrastructure and limit the expenses associated with moving, managing and storing diagnostic content and results.

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- o iConnect Network: An advanced interoperability network that allows hospitals and imaging centers to exchange radiology results with access to diagnostic quality images without having to build expensive point-to-point HL7 interfaces.

- o Honeycomb Archive: A cloud-based, multi-tenant image archive that provides disaster recovery/business continuity services for hospitals, imaging centers, and physician practices.

· Clinical and Financial Information Systems

- o Digital Imaging Solutions: Picture Archiving and Communication Systems (PACS), specialty workstations and related applications manage the image workflow of a medical enterprise. PACS can be used by any medical imaging provider at a hospital or outpatient imaging site. We offer PACS solutions for general image review and management, specialty solutions for cardiology, orthopaedics, ophthalmology, mammography and oncology, and add-on modules like referring physician portals and critical test results reporting. We also offer our eFilm Workstation for general radiology reading and CADstream workstations for specialty reading of magnetic resonance imaging (MRI) breast, liver and prostate studies.

- o Clinical information systems. These systems provide a complete electronic record of a medical procedure across a variety of specialties – including Merge OrthoEMR for orthopaedics, and Merge RIS for radiology.

- o Revenue Cycle Management. We offer software and services for the revenue cycle management of physician practices. These solutions can be used across many physician specialties, but our solutions are most commonly used by radiology practices, imaging centers and billing services.

· Software Development Toolkits, Technologies and Platforms.

- o Merge toolkits, technologies and platforms provide software developers with the necessary resources to assist in the timely development of new products and enhance existing products. They can be used by any original equipment manufacturer (OEM), medical device manufacturer, RIS/PACS or general healthcare IT vendors. We offer development toolkits in the basic standards of medical imaging and information interoperability, as well as advanced toolkits and unfinished applications for specialized medical image review and distribution.

· Hosted Software Solutions for Clinical Trial Data Management.

- o We provide hosted software solutions for the collection, aggregation, analysis, reporting and overall management of clinical trials information. These solutions can be sold to sponsors of clinical trials, including pharmaceutical companies, contract research organizations (CRO) or imaging core labs. Our solutions include electronic data capture (EDC), interactive voice/web response (IVR/IWR) and electronic patient reported outcomes (ePRO) software and devices.

Competition

The healthcare IT and imaging markets in which we participate are highly competitive, rapidly evolving and subject to rapid technological change. However, we believe that there is no single company that competes against our entire product portfolio.

Our principal competitors in the healthcare solutions and services market include: General Electric (Healthcare), McKesson Corporation, Fuji, Philips, Carestream, and Agfa, each of which offers software solutions that compete with a portion of our product portfolio. Almost all of these competitors are substantially larger or have more experience and market share than Merge in their respective markets. We also partner with certain of these companies to resell our products.

Other competitors focus on specific portions of the market that we address or compete against specific products we sell. For example, there are 30 other companies in the North American PACS market, according to Frost & Sullivan. These companies include original equipment manufacturers, former film companies and healthcare IT companies. Our eClinical solutions and services are in a highly competitive market led by Oracle and Medidata. Our OEM technologies most often compete with internal development departments, but also compete with software development companies for our DICOM and HL7 toolkits.

In addition, major software information systems companies, large information technology consulting service providers and system integrators, start-up companies, managed care companies and others, specializing in the healthcare industry, offer competitive software solutions or services. The pace of change in the healthcare IT market is rapid and there are frequent new software solutions or service introductions, enhancements and evolving industry standards and requirements. We believe that the principal competitive factors in this market include the breadth and quality of solution and service offerings, the stability of the solution provider, the quality, features and performance of the products, the ongoing support for the systems and the potential for enhancements and future compatible software solutions.

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Employees

At December 31, 2013, we had approximately 800 employees worldwide. Competition for personnel in the industry in which we compete is intense. We believe that our future success depends in part on our continued ability to hire, assimilate, train and retain qualified personnel.

Software Development

We commit significant resources to developing new health information system solutions. At December 31, 2013, approximately 215 of our employees were engaged in research and development activities. Total expenditures for the development and enhancement of our solutions were approximately $32.4 million, $32.4 million and $27.5 million during 2013, 2012 and 2011, respectively.

Our products, ranging from standards-based development toolkits to fully integrated clinical applications, have been used by healthcare providers worldwide for over 20 years. Our software solutions follow industry standards such as DICOM, which ensures that images from any DICOM-compliant imaging modality can be displayed, moved and stored within a standard set of guidelines. In addition, Merge follows the guidelines of the Integrating the Healthcare Enterprise (IHE) standards body, an organization dedicated to developing standard profiles for health information exchange. Our long-time involvement with the standards committees and continuous development of products like our DICOM and HL7 toolkits have enabled Merge to stay closely tied to industry innovation. As discussed above, continued investment in research and development remains a core element of our strategy. This will include ongoing enhancement of our core solutions and development of new solutions and services such as Honeycomb, our new cloud-based platform and iConnect Network, our new image and data exchange network.

Patents, Trademarks, Copyrights and Licenses

We regard our patents, trademarks, service marks, copyrights, trade secrets, proprietary technology and similar intellectual property as important to our success. Over time, we have assembled a portfolio of patents, trademarks, service marks, copyrights, trade secrets, proprietary technology and similar intellectual property covering our products and services and have registered. We have applied for the registration of U.S. and international trademarks, service marks, domain names, and copyrights and have filed U.S. and international patent applications covering certain of our proprietary technology. Our proprietary technology is not dependent on any single patent or copyright or groups of related patents or copyrights. We believe the duration of our patents is adequate relative to the expected lives of our products. We rely on trademark, copyright and patent law, trade secret protection and confidentiality and/or license agreements with employees, customers and others to protect our proprietary rights.

We hold inbound licenses for certain intellectual property that is used internally, and in some cases, utilized in our products or services. While it may be necessary in the future to seek or renew licenses relating to various aspects of our products and services, we believe, based upon past experience and industry practice, such licenses generally can be obtained on commercially reasonable terms. We believe our operations and products and services are not materially dependent on any single license or other agreement with any third party.

Sales, Marketing and Distribution

Sales to large health systems typically require a minimum of nine months development time, while the sales cycle can be shorter when selling to smaller hospitals and imaging centers. At December 31, 2013, approximately 130 of our employees were engaged in sales and marketing activities. Our executive sales and marketing management is located in Chicago, Illinois, while our sales team is deployed across the U.S. and globally.

We employ quota based sales teams that specialize in particular solutions and services. In addition, we have sales teams dedicated to establishing and maintaining distributor relationships on a global basis. We have concentrated inside and telesales staff in one location in order to bring economies of scale in management and process. Our sales teams are complemented by a staff of lead generation and marketing employees. These teams use online tools and resources that streamline and track the sales process.

Our marketing efforts are mainly electronic, utilizing our website and our extensive email database of customers for our communication campaigns, as well as our website for online communities and certain social media. Beyond electronic media, we employ consistent media relations efforts for market communications. In addition, we participate in the major industry trade shows for our respective product lines. We also have an active user group for our U.S. customers and an industry advisory board.

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Financial Information about Segments

For financial information regarding our two operating groups as well as our geographic areas of operation, refer to Item 8, “Note 1 – Basis of Presentation and Significant Accounting Policies” and “Note 14 – Segment Information and Concentrations of Risk” of this Annual Report on Form 10-K.

Item 1A. RISK FACTORS

Discussion of our business and operating results 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, prospects, or the market price of our common stock 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. We undertake no obligation to update or revise the statements.

Reductions in Medicare and Medicaid Reimbursement Rates for Imaging Procedures and Professional Services or Delays in the Payment of Reimbursements could Negatively Affect Revenues of our Hospital and Imaging Clinic Customers, which could cause our Customers to Reduce or Delay Purchases of our Software and Services.

The ability of customers to obtain appropriate reimbursement for their services from these programs and payors is critical to the success of our company. Reductions in the amount of reimbursements or uncertainty or delays in those reimbursements have in the past, and could in the future, cause our customers to cancel or delay making new expenditures on information technology. Federal budget reductions, such as the recent sequester by the federal government which cut $11.8 billion in Medicare reimbursements to medical providers during 2013, can affect the timing of the sales or our software and services.

In addition, the U.S. Congress has enacted far-reaching health system reform legislation that could have a negative impact on our business. While the impact of the legislation is difficult to predict, the legislation will increase pressure to control spending in government programs (e.g., Medicare and Medicaid) and by third party payors. For example, changes in the equipment utilization rate, once fully implemented, have the potential to decrease technical reimbursements for radiology procedures, and could have a particularly negative impact on hospitals and imaging clinics in rural regions of the country where utilization rates are naturally lower. A second significant potential reimbursement change relates to the Sustainable Growth Rate (SGR) component of the Medicare Physician Fee Schedule. The SGR is part of the update factor process used to set the annual rate of growth in allowed reimbursable medical expenditures, and is determined by a formula specified by Congress. Because the annual calculation of the SGR would have led to reimbursement reductions that Congress found unacceptable, Congress has interceded to delay the implementation of this statutory SGR update factor. While these changes have provided temporary reimbursement relief to healthcare providers and us, because of the significant budgetary impacts, Congress has retained the SGR formula, thereby allowing annual unimplemented payment reductions to accumulate in the Medicare statute. The Congress and the Obama administration are currently considering legislation to attempt to fix or delay this problem, but the prospects for enactment remain uncertain. The changes being considered have the potential to negatively impact the professional component of reimbursement.

Changes related to the equipment utilization assumption and the SGR calculation could result in a reduction in software and service procurement of our customers, and have a material adverse effect on our revenues and operating results.

We are Subject to Government Regulation, Changes to which could Negatively Impact our Business.

We are subject to regulation in the U.S. by the Food and Drug Administration (FDA), including periodic FDA inspections, in Canada under Health Canada's Medical Devices Regulations, and in other countries by corresponding regulatory authorities. We may be required to undertake additional actions in the U.S. to comply with the Federal Food, Drug and Cosmetic Act (FDCA"), regulations promulgated under the FDCA, and any other applicable regulatory requirements. For example, the FDA has increased its focus on regulating computer software intended for use in a healthcare setting. If our software solutions are deemed to be actively regulated medical devices by the FDA, we could be subject to more extensive requirements governing pre- and post-marketing activities. Complying with these regulations could be time consuming and expensive, and may include:

- Requiring us to receive FDA clearance of a pre-market notification submission demonstrating substantial equivalence to a device already legally marketed, or to obtain FDA approval of a pre-market approval application establishing the safety and effectiveness of the software;

- Requiring us to comply with rigorous regulations governing the pre-clinical and clinical testing, manufacture, distribution, labeling and promotion of medical devices; and

- Requiring us to comply with the FDCA regarding general controls, including establishment registration, device listing, compliance with good manufacturing practices, reporting of specified malfunctions and adverse device events.

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Similar obligations may exist in other countries in which we do business, including Canada. Any failure by us to comply with other applicable regulatory requirements, both domestic and foreign, could subject us to a number of enforcement actions, including warning letters, fines, product seizures, recalls, injunctions, total or partial suspensions of production, operating restrictions or limitations on marketing, refusals of the government to grant new clearances or approvals, withdrawals of marketing clearances or approvals and civil and criminal penalties.

We are subject to periodic FDA inspections and there can be no assurances that we will not be required to undertake additional actions to comply with the FDCA and any other applicable regulatory requirements. Any failure by us to comply with the FDCA and any other applicable regulatory requirements could have a material adverse effect on our ability to continue to manufacture and distribute our software solutions. The FDA has many enforcement tools including recalls, seizures, injunctions, civil fines and/or criminal prosecutions. Any of the foregoing could have a material adverse effect on our business, results of operations or financial condition.

Changes in Federal and State Regulations Relating to Data could Depress the Demand for our Software and Impose Significant Software Redesign Costs.

Federal regulations under the Health Insurance Portability and Accountability Act (HIPAA) impose national health data standards on healthcare providers that conduct electronic health transactions, healthcare clearinghouses that convert health data between HIPAA compliant and non-compliant formats and health plans. Collectively, these groups are known as covered entities. HIPAA regulations prescribe transaction formats and code sets for electronic health transactions, protect individual privacy by limiting the uses and disclosures of individually identifiable health information and require covered entities to implement administrative, physical and technological safeguards to ensure the confidentiality, integrity, availability and security of individually identifiable health information in electronic form. Although we are not a covered entity, most of our customers are, and they require that our software and services adhere to HIPAA regulations. Any failure or perceived failure of our software or services to meet HIPAA regulations, or any breach of the HIPAA regulations or any other federal, state or foreign data privacy laws or regulations, could result in remediation costs and fines, and could adversely affect demand for our software and services and potentially require us to expend significant capital, research and development and other resources to modify our software or services to address the privacy and security requirements of our clients.

States and foreign jurisdictions have adopted, or may adopt, privacy standards that are similar to or more stringent than the federal HIPAA privacy regulations. This may lead to different restrictions for handling individually identifiable health information. As a result, our customers may demand IT solutions and services that are adaptable to reflect different and changing regulatory requirements, which could increase our development costs. In the future, federal, state or foreign governmental authorities may impose new data security regulations or additional restrictions on the collection, use, transmission and other disclosures of health information. We cannot predict the potential impact that these future rules may have on our business; however, the demand for our software and services may decrease if we are not able to develop and offer software and services that can address the regulatory challenges and compliance obligations facing our clients.

Our Business could be Harmed by Adverse General Economic and Market Conditions.

Our markets have been and will continue to be affected by general economic and market conditions. If general economic conditions deteriorate or economic uncertainty continues in the markets in which we do business, our clients might experience deterioration of their businesses, cash flow shortages and difficulty obtaining financing which may impact the decisions of customers to purchase products that improve their processes and delay or reduce their purchases, and in our having higher customer receivables with increased default rates. General concerns about the fundamental soundness of domestic and foreign economies may also cause customers to reduce their purchases, even if they have cash or if credit is available to them. This could result in reductions in sales of our products, longer sales cycles, slower adoption of new technologies and increased price competition. In addition, weakness in the end-user market could negatively affect our OEM and VAR customers who could, in turn, delay paying their obligations, which would increase our credit risk exposure and cause a decrease in operating cash flows. Also, if OEM and VAR customers experience excessive financial difficulties and/or insolvency, and we are unable to successfully transition end-users to purchase products from other vendors or directly from us, sales could decline. Any of these events would likely harm our business, results of operations and financial condition.

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The Leverage Ratio Financial Covenant in our Credit Agreement may Force Us to Take Certain Actions that Could Adversely Affect our Future Results of Operations.

While we satisfied our Credit Agreement's leverage ratio financial covenant at the end of 2013, the Credit Agreement requires lower leverage ratios in future periods. Our ability to continue to satisfy the leverage ratio covenant going forward will depend on our future operating performance, which is in part subject to prevailing economic and competitive conditions and various financial, business, legislative, regulatory and other factors, some of which are beyond our control. If we cannot, or expect that we may not, meet the Credit Agreement's leverage ratio covenant in the future, we may need to dispose of material assets or operations, reduce or delay investments and capital expenditures, seek additional equity capital investments or negotiate to restructure or refinance our indebtedness. We may not be able to effect any such alternative measures on commercially reasonable terms or at all. Even if successful, such alternative measures may not allow us to meet the leverage ratio covenant in future periods, and/or they could limit our ability to realize the value of our assets and opportunities, restrict our ability to execute our long-term strategy or otherwise adversely affect our future results of operations.

We have a Substantial Amount of Indebtedness, which could Impact our Ability to Obtain Future Financing or Pursue our Growth Strategy.

We have substantial indebtedness. As of December 31, 2013, our indebtedness principally consisted of the Term Loan of $238.7 million. In addition, we may incur additional amounts under the Revolving Credit Facility of up to $20.0 million.

Our high level of indebtedness could have important consequences and significant adverse effects on our business, including the following:

- We must use a substantial portion of our cash flow from operations to pay interest on our indebtedness, which will reduce the funds available to us for operations and other purposes;

- We must use a substantial portion of the proceeds of any asset sales to repay our indebtedness;

- Our ability to obtain additional financing for working capital, capital expenditures, acquisitions or general corporate purposes may be limited;

- We are exposed to fluctuations in the interest rate environment because the interest rates under the Credit Facilities are variable;

- Our flexibility in planning for, or reacting to, changes in our business and the industry in which we operate may be limited, which may place us at a competitive disadvantage compared to our competitors that have less debt;

- Our ability to pursue additional business opportunities may be limited; and

- Our high level of indebtedness may make us more vulnerable to economic downturns and adverse developments in our business.

The Credit Agreement contains, and the instruments governing any indebtedness we may incur in the future may contain, restrictive covenants that impose significant operating and financial restrictions, including restrictions on our ability to take actions that we believe may be in our best interest. The Credit Agreement, among other things, limits our ability to:

- Incur additional indebtedness and issue preferred stock;

· Create or incur liens;

· Enter into certain sale-leaseback transactions;

· Make certain investments or certain other restricted payments or make certain capital expenditures or acquisitions;

· Merge or consolidate without meeting certain conditions;

· Sell assets;

· Pay dividends on our capital stock or redeem, repurchase or retire our capital stock or indebtedness;

· Enter into transactions with our affiliates;

· Guarantee indebtedness;

· Issue or sell stock of certain subsidiaries.

Our failure to comply with these restrictive covenants could result in an event of default which, if not cured or waived, could result in the acceleration of all or a portion of our outstanding indebtedness, which would have a material adverse effect on our business, financial condition and results of operations.

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Payments on our Indebtedness will Require a Significant Amount of Cash. Our Ability to Meet our Cash Requirements and Service our Indebtedness is Impacted by Many Factors that are Outside of our Control.

We expect to obtain the funds to pay our expenses and to pay the amounts due under the Credit Agreement primarily from our operations. Our ability to meet our expenses and make these payments thus depends on our future performance, which will be affected by financial, business, economic and other factors, many of which we cannot control. Our business may not generate sufficient cash flow from operations in the future and our currently anticipated growth in revenue and cash flow may not be realized, either or both of which could result in our being unable to service our indebtedness, including the Credit Agreement, meet the financial covenants in the Credit Agreement or to fund other liquidity needs. If we do not have sufficient cash resources in the future, we may be required to refinance all or part of our then existing indebtedness, sell assets or borrow more money. We cannot be assured that we will be able to accomplish any of these alternatives on terms acceptable to us or at all. See the section captioned “Liquidity and Capital Resources” in the Item 7, “Management’s Discussion and Analysis of Financial Condition and Results of Operations” in this Annual Report on Form 10-K.

We may Incur Substantial Additional Indebtedness that could Further Exacerbate the Risks Associated with our Indebtedness.

We may incur substantial additional indebtedness in the future. Although the Credit Agreement contains restrictions on our incurrence of additional indebtedness, these restrictions are subject to a number of qualifications and exceptions, and we could incur substantial additional indebtedness in the future, including additional secured indebtedness. In addition, we may refinance our existing indebtedness, which would permit us to incur additional indebtedness. If we incur additional indebtedness, certain of the risks described above would intensify. Our ability to meet our cash requirements and service our indebtedness is impacted by many factors that are outside of our control" would intensify.

Our Failure to Comply with the Credit Agreement, Including as a Result of Events Beyond our Control, Could Result in an Event of Default.

If there were an event of default under any of the agreements relating to the Credit Agreement, including as a result of our failure to meet the financial covenant included in the Credit Agreement with respect to our consolidated leverage ratio, we may not be able to incur additional indebtedness under the Credit Agreement and the holders of the defaulted debt could cause all amounts outstanding with respect to that debt to be due and payable immediately. We cannot assure you that our assets or cash flow would be sufficient to fully repay borrowings under our outstanding debt instruments if accelerated upon an event of default, which could have a material adverse effect on our ability to continue to operate as a going concern. Further, if we are unable to repay, refinance or restructure our secured debt, the holders of such debt could proceed against the collateral securing that indebtedness.

An Increase in Interest Rates Would Increase the Cost of Servicing our Debt and Could Reduce our Profitability.

The Credit Agreement provides that borrowings under the Credit Agreement bear interest at a variable rate. While we are able to mitigate the effects of interest rate changes pursuant to the Credit Agreement and through the use of hedging transactions, we will not completely eliminate the effect of interest rate changes. As a result, interest rate changes will not affect our obligation for any debt incurred under the Credit Agreement, but could affect the amount of our interest payments, and accordingly, our future earnings and cash flows, assuming other factors are held constant. An increase in interest rates, whether because of an increase in market interest rates or an increase in our own cost of borrowing, would increase the cost of servicing our debt and could materially reduce our profitability.

Inadequate Liquidity Could Materially Adversely Affect our Business Operations in the Future.

We require substantial liquidity to make interest payments on our indebtedness and run our normal business operations. We are subject to numerous risks and uncertainties that could negatively affect our cash flow and liquidity position in the future, including the other risks discussed under the heading "Risk Factors" in this Annual Report on Form 10-K. The occurrence of one or more of these events could weaken our liquidity position and materially adversely affect our business, for example by curtailing our ability to make important capital expenditures.

Our Performance Depends on our Ability to Attract and Retain Qualified Personnel.

We are dependent, in part, upon the services of our senior executives and other key business and technical personnel and competition for these type of highly skilled individuals is intense. We may not be able to retain existing key employees or be able to attract and retain skilled personnel on acceptable terms. We do not currently maintain key-man life insurance on our senior executives. Over the past year, we have made a number of changes to our senior executive management team, including at the position of chief executive officer, and certain of our sales and marketing personnel. It is important to our success that the new members of the senior executive management team and our new sales and marketing personnel quickly adapt and excel in their new roles. If we are unable to fill any open positions with adequately qualified employees who are capable of quickly learning the responsibilities associated with their positions, or we fail to retain those employees, our business and financial results could be materially adversely affected.

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Concerns About our Financial Stability Could Adversely Affect our Sales.

We rely on sales of software (including upgrades) and maintenance agreements for a significant portion of our revenue. Many of the customers in our industry expect to utilize software and services over a period of years and require access to upgrades and maintenance services during that time period. To the extent our customers have doubts about our financial stability and our ability to continue to operate as a going concern, those customers may seek alternative solutions from competitors who customers believe to be more financially stable. If our customers shift their business to our competitors who appear to be more financially stable, our revenues and results of operations could be adversely affected.

Our Future Capital Needs are Uncertain and our Ability to Access Additional Financing may be Negatively Impacted by the Volatility and Disruption of the Capital and Credit Markets and Adverse Changes in the Global Economy.

Our capital requirements in the future will depend on many factors, including:

· Acceptance of and demand for our products;

· The extent to which we invest in new technology and product development;

· The costs of developing new products, services or technologies;

· Our interest and principal payment obligations;

· The number and method of financing of acquisitions and other strategic transactions, if permitted; and

· The costs associated with the growth of our business.

We must continue to enhance and expand our product and service offerings to maintain our competitive position, satisfy our working capital obligations and increase our market share. We have in the past required substantial capital infusions. Our ability to incur additional indebtedness in the future may be limited or available only on disadvantageous terms. Unless we can achieve cash flow levels sufficient to support our operations, we may require additional borrowings or the sale of debt or equity securities, sale of non-strategic assets, or some combination thereof, to provide funding for our operations. Our ability to borrow in the future is dependent upon our ability to manage business operations and generate sufficient cash flows to service such indebtedness. If we are unable to generate sufficient working capital or obtain alternative financing, we may not be able to borrow or otherwise obtain additional funds to finance our operations when needed, our financial condition and operating results would be materially adversely affected.

If we experience a decrease in cash flows from operations, we may need additional financing to fund operations. Due to the existing uncertainty in the capital markets (including debt, private equity, venture capital and traditional bank lending), access to additional debt or equity may not be available on acceptable terms or at all. If we cannot raise funds on acceptable terms when necessary, we may not be able to develop or enhance products and services, execute our business plan, take advantage of future opportunities or respond to competitive pressures or unanticipated customer requirements.

Healthcare Industry Consolidation could Impose Pressure on our Software Prices, Reduce our Potential Client Base and Reduce Demand for our Software.

Many hospitals and imaging centers have consolidated to create larger healthcare enterprises with greater market power. If this consolidation trend continues, it could reduce the size of our potential customer base and give the resulting enterprises greater bargaining power, which may lead to erosion of the prices for our software. In addition, when hospitals and imaging centers combine, they often consolidate infrastructure, and consolidation of our customers could erode our revenue base.

We may Fail to Achieve our Financial Forecasts due to Inaccurate Sales Forecasts, Delays in Sales and Installation of our Products and Other Reasons.

We may not be able to accurately forecast our growth rate. We base expense levels and investment plans on sales estimates , which are reviewed on a quarterly basis, and signed customer contracts, which may be cancelable or subject to modification. Moreover, during 2013, we discovered that certain customer contracts had been falsified by a former employee. As a result, our revenues are difficult to forecast, and our operating results can fluctuate substantially. Because a significant portion of our cost structure, including expenses and investments, are fixed in the short-term, if revenues are lower than expected we may not be able to adjust spending quickly enough and as such we may experience a disproportionately negative impact on our profitability.

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Delays in the expected sales or installation of our software may have a significant impact on our anticipated quarterly revenues and, because a significant percentage of our expenses are relatively fixed, our earnings. Additionally, we sometimes depend, in part, upon large contracts with a small number of customers to meet sales goals in any particular quarter. Delays in the expected sales or installation of solutions under these large contracts may have a significant impact on our quarterly net sales and consequently our earnings.

We may Experience Significant Fluctuations in Revenue Growth Rates and Operating Results.

Our revenue growth may not be sustainable and our percentage growth rates may decrease or fluctuate significantly. Our revenue and operating profit growth depends on the continued growth of demand for our products and services offered through us or our OEM and VAR customers, and our business is affected by general economic and business conditions worldwide. A softening of demand, whether caused by changes in customer preferences or a weakening of the U.S. or global economies, may result in decreased revenue or growth. Our net sales and operating results will also fluctuate for many other reasons, including due to risks described elsewhere in this section.

The Length of our Sales and Implementation Cycles may Adversely Affect our Operating Results.

We have experienced long sales and implementation cycles. How and when to implement, replace, expand or substantially modify medical imaging management software, or to modify or add business processes, are major decisions for our end-user target market. The sales cycle for our software ranges from six to 18 months or more from initial contact to contract execution. Our end-user implementation cycle has generally ranged from three to nine months from contract execution to completion of implementation. During the sales and implementation cycles, we will expend substantial time, effort and resources preparing contract proposals, negotiating the contract and implementing the software, and may not realize any revenues to offset these expenditures. Additionally, any decision by our customers to delay or cancel purchases or the implementation of our software may adversely affect net sales.

We Operate in Competitive Markets, which may Adversely Affect our Market Share and Financial Results.

The markets for Healthcare IT solutions are highly competitive and subject to rapid technological change. We may be unable to maintain our competitive position against current and potential competitors. Some of our competitors are focused on sub-markets within targeted industries, while others have significant financial and information-gathering resources with recognized brands, technological expertise and market experience. We believe that competitors are continuously enhancing their products and services, developing new products and services and investing in technology to better serve the needs of their existing customers and to attract new customers. In addition, new competitors may emerge and our system and software solution offerings may be threatened by new technologies or market trends that reduce the value of our solutions.

We face competition in specific industries and with respect to specific offerings. We may also face competition from organizations and businesses that have not traditionally competed with us, but that could adapt their products and services to meet the demands of our customers. In addition, we often compete with our OEM customers' own internal software engineering groups. The size and competency of these groups may create additional competition. Increased competition may require us to reduce the prices of our offerings or make additional capital investments that would adversely affect margins. If we are unable or unwilling to do so, we may lose market share in target markets and our financial results may be adversely affected.

If We Are Unable to Successfully Identify or Effectively Integrate Acquisitions, our Financial Results may be Adversely Affected.

We have in the past and may in the future acquire and make investments in companies, products or technologies that we believe complement or expand our existing business and assist in quickly bringing new products to market. There can be no assurance that we will be able to identify suitable candidates for successful acquisitions at acceptable valuations. In addition, our ability to achieve the expected returns and synergies from past and future acquisitions depends in part upon our ability to integrate the offerings, technology, administrative functions, and personnel of these businesses into our business in an efficient and effective manner. We cannot predict whether we will be successful in integrating acquired businesses or that our acquired businesses will perform at anticipated levels. In addition, our past and future acquisitions may subject us to unanticipated risks or liabilities, or disrupt operations and divert management's attention from day-to-day operations. In addition, we may use our capital stock to acquire acquisition targets, which could be dilutive to the existing stockholders and cause a decline in the price of our common stock.

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In making or attempting to make acquisitions or investments, we face a number of risks, including risks related to:

- Identifying suitable candidates, performing appropriate due diligence, identifying potential liabilities and negotiating acceptable terms;
- The potential distraction of our management, diversion of our resources and disruption to our business;
- Retaining and motivating key employees of the acquired companies;
- Managing operations that are distant from our current headquarters and operational locations;
- Entering into industries or geographic markets in which we have little or no prior experience;
- Competing for acquisition opportunities with competitors that are larger or have greater financial and other resources than us;
- Accurately forecasting the financial impact of a transaction;
- Assuming liabilities of acquired companies, including existing or potential litigation related to the operation of the business prior to the acquisition;
- Reducing our working capital and hindering our ability to expand or maintain our business, if acquisitions are made using cash;
- Maintaining good relations with the customers and suppliers of the acquired company; and
- Effectively integrating acquired companies and achieving expected synergies.

In addition, any acquired business, products or technologies may not generate sufficient revenue and net income to offset the associated costs of such acquisitions, and such acquisitions could result in other adverse effects. In the years ended December 31, 2013, 2012 and 2011, we incurred \$0.9 million, \$3.4 million, and \$1.6 million of acquisition related costs, respectively. All such direct acquisition costs are expensed as incurred by us. In addition, we often are required to incur charges to operations in the quarters following an acquisition to reflect costs associated with integrating acquired companies. We anticipate that our acquisition activities will require cash outflows directly related to completing acquisitions as well as costs related to integration efforts. If the benefits of an acquisition do not exceed the costs of integrating the businesses, our financial results may be adversely affected.

Moreover, from time to time, we may enter into negotiations for the acquisition of businesses, products or technologies but be unable or unwilling to consummate the acquisitions under consideration. This can be expensive and could cause significant diversion of managerial attention and resources.

A Portion of our Business Relies Upon a Network of Independent Contractors and Distributors Whose Actions could have an Adverse Effect on our Business.

We obtain some critical information from independent contractors. In addition, we rely on a network of VARs and distributors to sell our offerings in locations where we do not maintain a sales office or direct sales team. These independent contractors, VARs and distributors are not our employees. As a result, we have limited ability to monitor and direct their activities. The loss of a significant number of these independent contractors, VARs or distributors could disrupt our sales, marketing and distribution efforts. Furthermore, if any actions or business practices of these individuals or entities violate our policies, procedures, or regulators to which we are subject, or otherwise are deemed inappropriate or illegal, we could be subject to litigation, regulatory sanctions or reputation damage, any of which could adversely affect our business and require us to terminate relationships with them.

Our Investments in Technology may not be Sufficient and may not Result in an Increase in our Revenues or Decrease in our Operating Costs.

As the technological landscape continues to evolve, it may become increasingly difficult for us to make timely, cost-effective changes to our product offerings to allow us to effectively compete against our competitors' product offerings. We cannot provide any assurance that our investments will result in successful applications that will be sufficient to maintain or improve our competitive position.

If our New and Existing Products, Including Product Upgrades and Services do not Achieve and Maintain Sufficient Market Acceptance, our Business, Financial Condition, Cash Flows, Revenues, and Operating Results could Suffer.

The success of our business depends and will continue to depend in large part on the market acceptance of:

- Our existing products and services;

- Our new products and services, and

- Enhancements to existing products support and services.

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There can be no assurance that customers will accept any of these products, product upgrades, support or services. In addition, even if customers accept these products and services initially, we cannot be assured that they will continue to purchase our products and services at levels that are consistent with, or higher than, past quarters. Customers may significantly reduce their relationships with us or choose not to expand their relationship with us. In addition, any pricing strategy that we implement for any of our products, product upgrades, or services may not be economically viable or acceptable to our target markets. Failure to achieve or to sustain significant penetration in our target markets with respect to any of these products, product upgrades, or services could have a material adverse effect on our business.

Achieving and sustaining market acceptance for these products, product upgrades and services is likely to require substantial marketing and service efforts and the expenditure of significant funds to create awareness and demand by participants in the healthcare industry. In addition, deployment of new or newly integrated products or product upgrades may require the use of additional resources for training our existing sales force and customer service personnel and for hiring and training additional sales and customer service personnel. There can be no assurance that the revenue opportunities for new products, product upgrades and services will justify the amounts that we spend for their development, marketing and rollout.

If we are unable to sell new and next-generation software products to healthcare providers that are in the market for healthcare information and/or image management systems, such inability will likely have a material adverse effect on our business, financial condition, cash flows, revenues and operating results. If anticipated software sales and services do not materialize, or if we lose customers or experience significant declines in orders from customers, our revenues would decrease over time due to the combined effects of attrition of existing customers and a shortfall in new client additions.

We may not be Able to Adequately Protect our Intellectual Property Rights or may be Accused of Infringing Intellectual Property Rights of Third Parties.

We regard our patents, trademarks, service marks, copyrights, trade secrets, proprietary technology and similar intellectual property as important to our success. Over time, we have assembled a portfolio of patents, trademarks, service marks, copyrights, trade secrets, proprietary technology and similar intellectual property covering our products and services and have registered. We have applied for the registration of, U.S. and international trademarks, service marks, domain names, and copyrights and have filed U.S. and international patent applications covering certain of our proprietary technology. Our proprietary technology is not dependent on any single patent or copyright or groups of related patents or copyrights. We believe the duration of our patents is adequate relative to the expected lives of our products. We rely on trademark, copyright and patent law, trade secret protection and confidentiality and/or license agreements with employees, customers and others to protect our proprietary rights.

We hold inbound licenses for certain intellectual property that is used internally, and in some cases, utilized in our products or services. While it may be necessary in the future to seek or renew licenses relating to various aspects of our products and services, we believe, based upon past experience and industry practice, such licenses generally can be obtained on commercially reasonable terms. We believe our operations and products and services are not materially dependent on any single license or other agreement with any third party.

We may not be able to discover or determine the extent of any unauthorized use of our intellectual property and proprietary rights. Third parties that license our proprietary rights also may take actions that diminish the value of these rights. Any claims of alleged infringement of the intellectual property rights of third parties, whether or not meritorious, may result in the expenditure of significant financial and managerial resources. If we are found liable for infringement, we may be required to pay damages or cease making or selling certain products. We may need to obtain licenses from third parties who allege that we have infringed on their rights, but such licenses may not be available on terms acceptable to us or at all. In addition, we may not be able to obtain or utilize on favorable terms, or at all, licenses or other rights with respect to intellectual property we do not own in providing services under commercial agreements. These risks have been amplified by the increase in third parties whose sole or primary business is to assert such claims.

We also rely on proprietary know how and confidential information and employ various methods, such as entering into confidentiality and non-compete agreements with our current employees and with certain third parties to whom we have divulged proprietary information to protect the processes, concepts, ideas and documentation associated with our solutions. Such methods may not afford sufficient protection, and we may not be able to protect trade secrets adequately or ensure that other companies would not acquire information that we consider proprietary, particularly in foreign countries where the laws may not protect our proprietary rights as fully as in the U.S. Our inability to protect our proprietary technology could result in competitive harm that could adversely affect our business.

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We have Foreign Exchange Rate Risk.

Our international operating results are exposed to foreign exchange rate fluctuations. While the functional currency of most of our international operations is the U.S. Dollar, we conduct transactions in currencies other than the U.S. Dollar, and certain account balances in foreign countries are maintained in the local currency. As such, changes in the value of certain foreign currencies relative to the U.S. Dollar can affect our revenues, operating results and the value of our foreign currency account balances. Generally, our revenues, operating results and foreign currency account balances are adversely affected when the dollar strengthens relative to other currencies and are positively affected with the dollar weakens. As we expand international operations, our exposure to exchange rate fluctuations may increase.

We may not be Successful in our Efforts to Expand into International Markets.

Our international activities are material to our revenues and profits, and we plan to further expand internationally. In 2013, our international revenues were $15 million, or about 7% of total revenues. We have limited experience operating in international markets and may not benefit from any first-to-market advantages or otherwise succeed. It is costly to establish, develop and maintain international operations and websites and promote our brand internationally. Our international operations may not be profitable on a sustained basis.

In addition to risks described elsewhere in this section, our international sales and operations are subject to a number of risks, including:

- Local economic and political conditions;
- Foreign government regulation of healthcare and government reimbursement of health services;
- Local restrictions on sales or distribution of certain products or services and uncertainty regarding liability for products and services;
- Local import, export or other business licensing requirements;
- Local limitations on the repatriation and investment of funds and foreign currency exchange restrictions;
- Shorter payable and longer receivable cycles and the resultant negative impact on cash flow;
- Local laws and regulations regarding data protection, privacy, network security and restrictions on pricing;
- Difficulty in staffing, developing and managing foreign operations as a result of distance, language and cultural differences;
- Different employee/employer relationships and the existence of workers' councils and labor unions;
- Laws and policies of the U.S. and other jurisdictions affecting trade, foreign investment, loans and taxes; and
- Geopolitical events, including war and terrorism.

Litigation or Regulatory Actions could Adversely Affect our Financial Condition.

As a result of lawsuits and regulatory matters, including the matters discussed in Item 3, Legal Proceedings in this Annual Report on Form 10-K, we have incurred and may continue to incur substantial expenses. In addition, we are, from time to time, parties to legal and regulatory proceedings, lawsuits and other claims incident to our business activities. Such matters may include, among other things, assertions of contract breach or intellectual property infringement, claims for indemnity arising in the course of our business and claims by persons whose employment has been terminated. Such matters are subject to many uncertainties and outcomes are not predictable. The defense of these actions may be both time consuming and expensive. We are unable to estimate the ultimate aggregate amount of monetary liability, amounts which may be covered by insurance or recoverable from third parties, or the financial impact with respect to these matters as of the date of this Annual Report on Form 10-K. If any of these legal proceedings were to result in an unfavorable outcome, it could have a material adverse effect on our business, financial position and results of operations.

We may be Subject to Product Liability Claims if People or Property are Harmed by the Products and Services that we Sell.

Some of the products we sell or manufacture may expose us to product liability claims relating to personal injury, death or environmental or property damage and may require product recalls or other actions. Moreover, because our products are intended to be used in connection with providing medical care to patients, users of our products may have a greater sensitivity to errors than in the general market for software products. If our products lead to faulty medical decisions or injury to patients, we could be exposed to claims or litigation that could have an adverse effect on our business. Certain third parties, primarily our customers, also sell products or services using our products. This may increase our exposure to product liability claims. Although we maintain liability insurance, we cannot be certain that coverage will be adequate for liabilities actually incurred or that insurance will continue to be available on economically reasonable terms or at all. In addition, some of our agreements with vendors and sellers do not indemnify us from product liability. Even unsuccessful claims could result in substantial costs and diversion of management resources. A claim brought against us that is uninsured or under-insured could harm our business, financial condition and results of operations.

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We Provide Customers with Certain Warranties that could Result in Higher Costs than Anticipated.

Software products such as ours that are used in a wide range of clinical and health information systems settings may contain a number of errors or "bugs," especially early in their product life cycle. Our products include clinical information systems used in patient care settings where a low tolerance for errors or bugs exists. Testing of products is difficult due to the wide range of environments in which systems are installed. The discovery of defects or errors in our software products or in our implementation of integrated solutions may cause delays in product delivery, poor client references, payment disputes, contract cancellations, harm to our reputation, product liability claims or additional expenses and payments to rectify problems. Furthermore, our customers might use our software together with products from other companies or those that they have developed internally. As a result, when problems occur, it might be difficult to identify the source of the problem. Even when our software does not cause these problems, the existence of these errors might cause us to incur significant costs, divert the attention of our technical personnel from our research and development efforts; impact our reputation and cause significant customer relations problems. Any of those factors may result in delayed acceptance of, or the return of, our software products.

We Depend on Licenses from Third Parties for Rights to Some Technology we use, and if we are Unable to Continue these Relationships and Maintain our Rights to this Technology, our Business could Suffer.

Some of the technology used in our software depends upon licenses from third party vendors. These licenses typically expire within one to five years, can be renewed only by mutual consent and may be terminated if we breach the license and fail to cure the breach within a specified period of time. We may not be able to continue using the technology made available to us under these licenses on commercially reasonable terms or at all. As a result, we may have to discontinue, delay or reduce software shipments until we obtain equivalent technology, if available, which could hurt our business. Most of our third party licenses are nonexclusive. Our competitors may obtain the same right to use any of the technology covered by these licenses and use the technology to compete directly with us. In addition, if our vendors choose to discontinue support of the licensed technology in the future or are unsuccessful in their continued research and development efforts, particularly with regard to the Microsoft Windows/Intel platform on which most of our products operate, we may not be able to modify or adapt our own software. This could have an adverse effect on our business.

Our Large Stockholders may have Interests that Differ from other Stockholders.

Merrick Ventures, LLC (Merrick Ventures) and its affiliates, including Merrick Venture Management Holdings, LLC (Merrick Holdings), beneficially own, as of December 31, 2013, 27.5% of our outstanding common stock. Michael W. Ferro, Jr., our former Chairman of the Board, and trusts for the benefit of Mr. Ferro's family members beneficially own a majority of the equity interests in Merrick Ventures and Merrick Holdings. Mr. Ferro also serves as the chairman and chief executive officer of Merrick Ventures and Merrick Holdings. Accordingly, Mr. Ferro indirectly owns or controls all of the shares of our common stock owned by Merrick Ventures and Merrick Holdings. Due to their stock ownership, Merrick Ventures and Merrick Holdings have significant influence over our business, including the election of our directors.

In addition, as discussed in Note 10 of the notes to consolidated financial statements included in this Annual Report on Form 10-K, we have been a party to certain related-party transactions with affiliates of Merrick Ventures and Merrick Holdings. The interests of Merrick Ventures, Merrick Holdings and their affiliates may differ from those of our other stockholders. Merrick Ventures, Merrick Holdings and their affiliates are in the business of making investments in companies and maximizing the return on those investments. They currently have, and may from time to time in the future acquire, interests in businesses that directly or indirectly compete with certain aspects of our business or that supply us with goods and services. Merrick Ventures, Merrick Holdings and their affiliates may also pursue acquisition opportunities that may be complementary to our business and, as a result, those acquisition opportunities may not be available to us. Merrick Ventures' and Merrick Holdings' significant ownership of our voting stock will enable it to influence or effectively control us.

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There are a Limited Number of Stockholders who have Significant Control over our Common Stock, Allowing them to have Significant Influence over the Outcome of all Matters Submitted to Stockholders for Approval, which may Conflict with our Interests and the Interests of other Stockholders.

Our directors, officers and principal stockholders (stockholders owning 10% or more of our common stock) beneficially owned approximately 31.3 million, or 32.3%, of the outstanding shares of common stock and stock options that could have been converted to common stock at December 31, 2013, and such stockholders will have significant influence over the outcome of all matters submitted to our stockholders for approval, including the election of directors and other corporate actions. As of December 31, 2013, Merrick Ventures, Merrick Holdings and their affiliates owned approximately 27.5% of our common stock. The influence of our large stockholders could impact our business strategy and also have the effect of discouraging others from attempting us to take over, thereby increasing the likelihood that the market price of our common stock will not reflect a premium for control.

Shares of our Common Stock Eligible for Public Sale may have a Negative Impact on the Market Price of our Common Stock.

Sales of a substantial number of shares of our common stock in the public market, or the perception that these sales may occur, could cause the market price of our common stock to decline. In addition, the sale of these shares could impair our ability to raise capital, should we wish to do so, through the sale of additional common or preferred stock. As of December 31, 2013, we had approximately 96.7 million shares of common stock outstanding. In addition, as of December 31, 2013, we had outstanding options to purchase approximately 8.9 million shares of our common stock, of which approximately 6.2 million options were exercisable, including 800,000 and 200,000 options held by our named executive officers that we expect to be exercised on or before their expiration dates of June 3, 2014 and August 18, 2014, respectively. Future sales of shares of our common stock by existing holders of our common stock or by holders of outstanding options, upon the exercise thereof, could have a negative impact on the market price of our common stock. As additional shares of common stock become available for sale in the public market, due to the exercise of options or the issuance of shares as a result of acquisitions, the market supply of shares of common stock will increase, which could also decrease the market price.

We are unable to estimate the number of shares that may be sold because this will depend on the market price for our common stock, the personal circumstances of the sellers and other factors. Any sale of substantial amounts of our common stock or other securities in the open market may adversely affect the market price of such securities and may adversely affect our ability to obtain future financing in the capital markets as well as create a potential market overhang.

Because we do not Intend to Pay Cash Dividends, Stockholders will Benefit from an Investment in our Stock Only if it Appreciates in Value.

We currently intend to retain future earnings, if any, to fund future growth, and do not expect to pay any cash dividends in the foreseeable future. As a result, the success of an investment in our common stock will depend upon any future appreciation in its value. There is no guarantee that our common stock will appreciate in value or even maintain the price at which stockholders have purchased and will purchase shares.

The Trading Price of our Common Stock has been Volatile and may Fluctuate Substantially in the Future.

The price of our common stock has been, and may continue to be, volatile. The trading price of our common stock may continue to fluctuate widely as a result of a number of factors, some of which are not in our control, including:

- Our ability to meet or exceed the expectations of analysts or investors;

- Changes in our forecasts or earnings estimates by analysts;
- Quarter-to-quarter variations in our operating results;
- Announcements regarding clinical activities or new products by us or our competitors;
- General conditions in the healthcare IT industry;
- Governmental regulatory action and healthcare reform measures, including changes in reimbursement rates for imaging procedures;
- Rumors about our performance or software solutions;
- Announcements regarding acquisitions;
- Uncertainty regarding our ability to service existing debt;
- Price and volume fluctuations in the overall stock market, which have particularly affected the market prices of many software, healthcare and technology companies; and
- General economic conditions.

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In addition, the market for our common stock may experience price and volume fluctuations unrelated or disproportionate to our operating performance. These fluctuations could have a significant impact on our business due to diminished incentives for management and diminished currency for acquisitions.

If our Operating and Financial Performance Does not Meet the Guidance that we Have Provided to the Public, our Stock Price may Decline.

Periodically, we provide public guidance on our expected operating and financial results for future periods. Although we believe that this guidance provides investors and analysts with a better understanding of management's expectations for the future and is useful to our stockholders and potential stockholders, such guidance is comprised of forward-looking statements subject to the risks and uncertainties described in this report and in our other public filings and public statements. Our actual results may not always be in line with or exceed the guidance we have provided, especially in times of economic uncertainty. If our financial results for a particular period do not meet our guidance or the expectations of investment analysts, or if we reduce our guidance for future periods, the market price of our common stock may decline.

Certain Provisions of our Certificate of Incorporation, Bylaws and Delaware law could make a Takeover Difficult and May Prevent or Frustrate Attempts by our Stockholders to Replace or Remove our Management Team.

Various provisions contained in our certificate of incorporation and bylaws could delay or discourage some transactions involving an actual or potential change in control and may limit the ability of our stockholders to remove current management or approve transactions that our stockholders may deem to be in their best interests. For instance, we have an authorized class of 1,000,000 shares of preferred stock all of which shares are undesignated except for 50,000 shares of Series A Preferred Stock (none of which were issued and outstanding as of December 31, 2013 and 2012). Shares of our authorized but unissued preferred stock may be issued by our board of directors without stockholder approval, on such terms and with such rights, preferences and designation as the board of directors may determine. Issuance of such preferred stock, depending upon the rights, preferences and designations thereof, may have the effect of delaying, deterring or preventing a change in control of us.

In addition, provisions of our certificate of incorporation and bylaws:

- Require that any action required or permitted to be taken by our stockholders be effected at a duly called annual or special meeting of stockholders and may not be effected by any consent in writing;

- Provide an advance written notice procedure with respect to stockholder proposals and the nomination of candidates for election as directors, other than nominations made by or at the direction of our board of directors or a committee of our board of directors;

- State that special meetings of our stockholders may be called only by the chairman of our board of directors, our chief executive officer or by a majority of our board of directors then in office; and

- Allow our directors to fill vacancies on our board of directors, including vacancies resulting from removal or enlargement of the board of directors.

We are also subject to provisions of Delaware corporate law which, subject to certain exceptions, will prohibit us from engaging in any “business combination” with a person who, together with affiliates and associates, owns 15% or more of our common stock for a period of three years following the date that the person came to own 15% or more of our common stock, unless the business combination is approved in a prescribed manner.

These provisions of our certificate of incorporation, bylaws and of Delaware law, may have the effect of delaying, deterring or preventing a change in control, may discourage bids for our common stock at a premium over market price and may adversely affect the market price, and the voting and other rights of the holders, of our common stock. In addition, these provisions make it more difficult to replace or remove our current management team in the event our stockholders believe this would be in our best interest and the best interests of our stockholders.

Some of our Activities may Subject us to Risks under Laws and Regulations relating to Healthcare Fraud.

We are subject to extensive and frequently changing local, state and federal laws and regulations relating to healthcare fraud, waste and abuse, and the government, both state and federal, continues to strengthen its position and scrutiny over practices involving fraud, waste and abuse affecting Medicare, Medicaid and other government healthcare programs. Our relationships with hospitals and imaging centers, as well as our provision of products and services to government entities, subject our business to laws and regulations on fraud and abuse, which among other things: (1) prohibit persons from soliciting, offering, receiving or paying any remuneration in order to induce the referral of a patient for treatment or for inducing the ordering or purchasing of items or services that are in any way paid for by Medicare, Medicaid or other government-sponsored healthcare programs; (2) impose a number of restrictions upon referring physicians and providers of designated health services under Medicare and Medicaid programs; and (3) prohibit the knowing submission of a false or fraudulent claim for payment to, and knowing retention of an overpayment by, a federal health care program such as Medicare and Medicaid. Many of the regulations applicable to us, including those relating to marketing incentives, are vague or indefinite and have not been interpreted by the courts. They may be interpreted or applied by a prosecutorial, regulatory, or judicial authority in a manner that could require us to make changes in our operations. If we fail to comply with applicable laws and regulations, we could become liable for damages, suffer civil and criminal penalties, including the loss of licenses or our ability to participate in Medicare, Medicaid and other federal and state healthcare programs.

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Our Failure to Comply with Evolving Interoperability Standards could Depress the Demand for our Software and Impose Significant Software Redesign Costs.

There is increasing demand among customers, industry groups and government authorities that healthcare software and systems provided by various vendors be compatible with each other. This need for interoperability is leading to the development of standards by various groups, and certain federal and state agencies are also developing standards that could become mandatory for systems purchased by these agencies. For example, the HITECH Act requires meaningful use of “certified” healthcare information technology products by healthcare providers in order to receive stimulus funds from the federal government. Effective September 27, 2010, Centers for Medicare and Medicaid Services (“CMS”) issued a rule that utilizes a staged approach for defining meaningful use criteria. Under the staged approach, CMS has issued rules that identify the initial criteria for meaningful use and is updating these initial criteria with additional rules. On September 4, 2012, CMS published a final rule that specifies the Stage 2 criteria that eligible professionals, eligible hospitals, and critical access hospitals must meet in order to continue to participate in the Medicare and Medicaid Electronic Health Record Incentive Programs. All providers must achieve meaningful use under the Stage 1 criteria before moving to Stage 2. In addition, these standards are subject to interpretation by the entities designed to certify such technology. A combination of our solutions has been certified as meeting the initial criteria. However, we may incur increased development costs and delays in upgrading our customer software and systems to be in compliance with these varying and evolving standards. In addition, these new standards may lengthen our sales and implementation cycle and we may incur costs in periods prior to the corresponding recognition of revenue. To the extent these standards are narrowly construed or delayed in publication, or that we are delayed in achieving certification under these evolving standards for applicable products, our customers may postpone or cancel their decisions to purchase or implement our software and systems.

Item 1B. UNRESOLVED STAFF COMMENTS

None.

Item 2. PROPERTIES

Our five largest facilities, all of which are leased, are set forth in the following table:

Location	Square Footage	Annual Lease Payments (thousands of $)
Chicago, Illinois	22,633	$ 367
Daytona Beach, Florida	36,000	177
Hartland, Wisconsin	81,000	716
Mississauga, Ontario	24,000	665
Morrisville, North Carolina	14,746	241

We actively monitor our real estate needs in light of our current utilization and projected growth. We believe that we can acquire any necessary additional facility capacity on reasonably acceptable terms within a relatively short timeframe. We devote capital resources to facility improvements and expansions as we deem necessary to promote growth and most effectively serve our customers.

Item 3. LEGAL PROCEEDINGS

On June 1, 2009, Merge Healthcare was sued in the Milwaukee County Circuit Court, State of Wisconsin, by William C. Mortimore and David M. Noshay with respect to the separation of Mortimore's and Noshay's employment and our subsequent refusal to indemnify them with respect to litigation related to their services as officers of Merge. The plaintiffs allege that we breached their employment agreements, unreasonably refused their requests for indemnification and breached other covenants of good faith and fair dealing. The plaintiffs seek indemnification and unspecified monetary damages. On April 6, 2011, the Milwaukee County Circuit Court rendered a decision in which it concluded that Merge and Mortimore had entered into an oral employment contract on or about June 15, 2006, but the Court did not make any decision as to damages, which damages would be addressed in a later phase of the litigation. On May 9, 2011, Merge appealed the Circuit Court's decision. On September 18, 2012, the Appellate Court issued its decision reversing the trial court and determined that Mortimore must arbitrate his disputes with Merge. On June 18, 2013, Merge and Mortimore participated in a hearing before the arbitrator. On July 17, 2013, the arbitrator rendered a reasoned award in which he concluded that Merge and Mortimore did not enter into an oral contract. As a result, Mortimore's claims and Merge's counterclaims were heard at arbitration from March 3, 2014 through March 7, 2014. A decision from the arbitrator is pending. Following the arbitrator's ruling in July 2013, Mr. Noshay filed a motion to lift the stay as to his claims. The Court granted Mr. Noshay's motion and set a discovery schedule with a trial expected to be set in the third or fourth quarter of 2014. We believe it is reasonably possible that we may incur a loss with respect to these matters; however, at this stage of the proceedings, it is not possible for management to reasonably estimate the amount of any potential loss.

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In January and February 2010, purported stockholder class action complaints were filed in the Superior Court of Suffolk County, Massachusetts in connection with AMICAS Inc.'s (AMICAS) proposed acquisition by a third party. In March 2010, because AMICAS had terminated the merger agreement with that third party and agreed to be acquired by Merge, the Court dismissed the plaintiffs' claims as moot. Subsequently, plaintiffs' counsel filed an application for approximately $5.0 million of attorneys' fees. AMICAS opposed the fee petition, tendered the defense to its insurers that provided coverage against such claims and retained litigation counsel to defend the matter. On December 4, 2010, the Massachusetts court awarded plaintiffs approximately $3.2 million in attorneys' fees and costs. AMICAS appealed this judgment to the Massachusetts Court of Appeals. After receipt of the Massachusetts court's attorneys' fee award decision, AMICAS's insurer denied policy coverage for approximately $2.5 million of the fee award and filed a declaratory judgment action to that effect against AMICAS and Merge in Federal court for the Northern District of Illinois. We contested the insurer's denial of coverage, asserted our rights under the applicable insurance policies and filed a counterclaim against the insurer seeking full payment of the Massachusetts court's fee award, plus additional damages. On April 30, 2012, the Illinois Federal court ruled in favor of our motion for summary judgment, which decision was appealed by the insurer to the United States Seventh Circuit Court of Appeals. In late February 2013, the insurer settled the Massachusetts court case by agreeing to pay $3.0 million to plaintiffs' counsel and further agreeing not to pursue AMICAS or Merge for any portion of the amount paid. As a result of the Massachusetts settlement, we recognized a gain of $2.5 million within general and administrative expense in our statement of operations with respect to these matters in the year ended December 31, 2013 based on the February 27, 2013 Massachusetts appellate court dismissal date. On July 16, 2013, the Seventh Circuit Court of Appeals affirmed the Federal District court's decision in all respects and entered Final Judgment.

In August 2010, Merge Healthcare was sued in the Northern District of Texas by the Court-appointed receiver for Stanford International Bank, Ltd. The receiver alleges that Merge was a recipient of a fraudulent conveyance as a result of a Ponzi scheme orchestrated by Robert Stanford and Stanford International Bank, Ltd. (SIBL). Merge is not alleged to have participated in the Ponzi scheme. The receiver's claims arise from the failed acquisition of Emageon, Inc. (Emageon) by Health Systems Solutions, Inc. (HSS), an affiliate of SIBL, in February 2009, which resulted in the payment of a $9.0 million break-up fee by HSS, which payment is alleged to have been financed by SIBL. Merge subsequently acquired Emageon as part of our AMICAS acquisition. The complaint seeks to recover the $9.0 million payment to Emageon, plus interest, costs, and attorneys' fees. We have retained litigation counsel and intend to vigorously defend this action. We have filed a motion to dismiss the complaint. That motion has been fully briefed, and we are awaiting a decision from the Court. We believe it is reasonably possible that we may incur a loss with respect to this matter. The potential loss may lie in a range from zero to the full amount claimed, plus interest.

In September 2012, Merge Healthcare was sued in the Middle District of North Carolina by Heart Imaging Technologies, LLC (HIT). HIT alleged that certain features of products within our Image Interoperability Platform infringed three of HIT's patents related to internet-based image viewing. On December 7, 2013, Merge Healthcare and HIT executed a non-exclusive patent license and settlement agreement (Settlement Agreement). The Settlement Agreement settled all claims between the parties and provides Merge Healthcare with access to HIT's complete portfolio of healthcare information patents. Merge Healthcare agreed to pay HIT $1.4 million ratably over 11 years beginning in 2013, to collaborate on future products and to make certain contingent payments to HIT if Merge Healthcare incorporates other zero footprint technologies into Merge Healthcare's products and is not licensing HIT's zero footprint technology if it is still being offered. The suit was dismissed with prejudice pursuant to a joint stipulation filed December 17, 2013.

On January 16, 2014, a purported shareholder class action complaint was filed in the United States District Court for the Northern District of Illinois by Fernando Rossy, who claims to be a Merge Healthcare stockholder, against Merge Healthcare and certain current and former directors and officers claiming violations of federal securities laws and asserting that a class of our stockholders suffered damages due to the alleged dissemination or approval of false and misleading statements by Merge Healthcare from August 1, 2012 through January 7, 2014 related to falsified subscription backlog figures and a reluctance amongst large health systems to make enterprise purchases, as well as a lack of effective controls. On February 14, 2014, William B. Federman, who claims to be a Merge Healthcare stockholder, filed a derivative complaint in the Circuit Court of Cook County, Illinois against certain of our current and former directors and officers, asserting breaches of fiduciary duty arising out of materially the same conduct alleged in the securities fraud class action complaint. Subsequently, other similar class action and derivative complaints have been filed. The plaintiffs in these cases have not claimed a specific amount of damages. We expect these complaints to be consolidated into one or two actions. Merge Healthcare and the other named defendants are actively considering all possible responses to these complaints. While we intend to defend the claims vigorously and carry directors and officers insurance, it is reasonably possible that we may incur a loss in this matter. At this stage of the proceedings, however, it is not possible for management to reasonably estimate either the likelihood of such a loss or its magnitude.

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In addition to the matters discussed above, we are involved in various legal matters that are in the process of litigation or settled in the ordinary course of business. Although the final results of all such matters and claims cannot be predicted with certainty, we believe that the ultimate resolution of all such matters and claims will not have a material adverse effect on Merge's financial condition. Professional legal fees are expensed when incurred. We accrue for contingent losses when such losses are probable and reasonably estimable. In the event that estimates or assumptions prove to differ from actual results, adjustments are made in subsequent periods to reflect more current information. Should we fail to prevail in any legal matter or should several legal matters be resolved against us in the same reporting period, such matters could have a material adverse effect on our operating results and cash flows for that particular period.

Item 4. MINE SAFETY DISCLOSURES

Not applicable.

PART II

Item 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Our common stock trades on The NASDAQ Global Select Market (NASDAQ). The following table sets forth for the periods indicated, the high and low sale prices of our common stock as reported by the NASDAQ:

Common Stock Market Prices

2013	4th Quarter	3rd Quarter	2nd Quarter	1st Quarter
High	$ 2.82	$ 4.71	$ 3.79	$ 3.13
Low	$ 2.13	$ 2.35	$ 2.81	$ 2.27

2012	4th Quarter	3rd Quarter	2nd Quarter	1st Quarter
High	$ 3.92	$ 4.05	$ 5.96	$ 6.90
Low	$ 2.41	$ 2.76	$ 2.20	$ 4.42

According to the records of American Stock Transfer & Trust Company, our registrar and transfer agent, we had 446 shareholders of record of common stock as of March 3, 2014.

For information regarding securities authorized for issuance under our equity compensation plans, see Note 8 of the notes to consolidated financial statements included in this Annual Report on Form 10-K.

Stock Price Performance Graph

The graph below compares the cumulative total return on our common stock with the Russell 2000 Index and the NASDAQ Computer Index (U.S. companies) for the period from December 31, 2008 to December 31, 2013. The comparison assumes that $100 was invested on December 31, 2008 in our common stock and in each of the comparison indices, and assumes reinvestment of dividends, where applicable. We have selected the Russell 2000 index for comparison purposes as we do not believe we can reasonably identify an appropriate peer group index. The comparisons shown in the graph below are based upon historical data. The stock price performance shown in the graph below is not indicative of, nor intended to forecast, the potential future performance of our common stock.

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COMPARISON OF THE 5 YEAR CUMULATIVE TOTAL RETURNS
FOR THE FIVE YEAR PERIOD ENDED DECEMBER 31, 2013

Date	Merge Healthcare Incorporated (Nasdaq: MRGE)	Nasdaq Computer Index (^IXCO)	Russell 2000 Index (^RUT)
12/31/2008	$ 100	$ 100	$ 100
12/31/2009	$ 263	$ 171	$ 125
12/31/2010	$ 291	$ 201	$ 157
12/31/2011	$ 379	$ 202	$ 148
12/31/2012	$ 193	$ 227	$ 170
12/31/2013	$ 181	$ 299	$ 233

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Dividend Policy

We are prohibited from making certain dividend payments based on the terms of the Credit Agreement for our Term Loan and Revolving Credit Facility and have not declared any cash dividends on our common stock in the past two fiscal years. We currently do not intend to declare or pay any cash dividends on our common stock in the foreseeable future.

Item 6.   SELECTED FINANCIAL DATA

The following selected historical financial data is qualified in its entirety by reference to, and should be read in conjunction with, our consolidated financial statements and the related notes thereto appearing elsewhere herein and Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations" in this Annual Report on Form 10-K.

	Years Ended December 31,				
	2013	2012	2011	2010 (1)	2009 (2)
	(in thousands, except for share and per share data)				
Statement of Operations Data:					
Net sales	$231,667	$248,904	$232,428	$140,332	$66,841
Operating income (loss)	9,807	6,620	29,155	(8,524)	8,963
Income (loss) before income taxes	(36,094)	(24,729)	(1,866)	(25,162)	150
Income tax expense (benefit)	2,889	4,091	3,665	(13,646)	(135)
Net income (loss)	(38,983)	(28,820)	(5,531)	(11,516)	285
Net income (loss) attributable to Merge	(38,980)	(28,802)	(5,521)	(11,516)	285
Net income (loss) available to common shareholders	(38,980)	(28,802)	(8,674)	(30,592)	285
Earnings (loss) per share:					
Basic	$(0.42)	$(0.31)	$(0.10)	$(0.38)	$(0.00)
Diluted	(0.42)	(0.31)	(0.10)	(0.38)	$(0.00)
Weighted average shares outstanding:					
Basic	93,727,394	92,128,717	86,647,097	80,231,427	60,910,268
Diluted	93,727,394	92,128,717	86,647,097	80,231,427	62,737,821

	December 31,				
	2013	2012	2011	2010 (1)	2009 (2)
	(in thousands)				
Balance Sheet Data:					
Working capital	$12,014	$43,201	$46,020	$28,357	$18,231
Total assets	382,411	436,853	450,387	396,645	100,249
Long-term debt obligations	233,942	250,046	249,438	195,077	-
Shareholders' equity	45,260	77,461	92,471	104,806	68,137

(1) Includes the results of AMICAS from April 28, 2010, the date of the business combination.

(1) Includes the results of etrials and Confirma from July 20, 2009 and September 1, 2009, the respective dates of the business combinations.

Item 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The discussion below contains "forward-looking statements. We have used words such as "believes," "intends," "anticipates," "expects" and similar expressions to identify forward-looking statements. These statements are based on information currently available to us and are subject to a number of risks and uncertainties that may cause our actual results of operations, financial condition, cash flows, performance, business prospects and opportunities and the timing of certain events to differ materially from those expressed in, or implied by, these statements. These risks, uncertainties and other factors include, without limitation, those matters discussed in Item 1A of Part I of this Annual Report on Form 10-K. Except as expressly required by the federal securities laws, we undertake no obligation to update such factors or to publicly announce the results of any of the forward-looking statements contained herein to reflect future events, developments, or changed circumstances, or for any other reason. The following discussion should be read in conjunction with our consolidated financial statements and notes thereto appearing elsewhere in this Annual Report on Form 10-K and Item 1A, "Risk Factors".

Management's Discussion and Analysis is presented in the following order:

- Overview
- Business Segments
- Revenue and Expenses
- Results of Operations
- Liquidity and Capital Resources
- Material Off Balance Sheet Arrangements

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- Critical Accounting Policies

Overview

We develop enterprise imaging software solutions that facilitate the management of images to create a more effective and efficient electronic healthcare experience for patients and physicians. Our solutions are designed to help solve some of the most difficult challenges in health information exchange today, such as the incorporation of medical images and diagnostic information into broader healthcare IT applications, the interoperability of proprietary software solutions, and the ability to improve the efficiency and cost effectiveness of our customers' businesses. We believe that our ability to innovate has driven consistent expansion of solutions and services and entry into new markets.

Our solutions optimize processes for healthcare providers ranging in size from single provider practices to large health systems, to the sponsors of clinical trials and medical device manufacturers.

We believe that certain macro events that occurred in 2013 impacted our operating results (together with those of others in our industry), most notably:

- The U.S. Federal government's sequester, which started in April, cut over $11 billion, or 2%, in Medicare reimbursements to providers, and

- An anticipated delay in converting from ICD-9 to ICD-10 did not occur when it was announced on June 17, 2013 that the deadline for conversion would remain Oct. 1, 2014. We believe this caused many clients and prospects to delay decisions on any projects not directly related to their transition to ICD-10.

To ensure we maintain a continued, disciplined approach of cost alignment to sales expectations, we reorganized our leadership team and sales organization to focus on our core markets and right-sized our cost structure, primarily within sales and marketing, in the third quarter of 2013. Since we believe that market opportunities still exist over the long-term for our products and the solutions we have developed, these actions did not impact our product research and development costs as we have decided to continue to invest meaningfully in our product solutions. We believe that investment in our development has been validated, most recently by being ranked the 8th best software vendor overall in KLAS Research's 2013 Best in KLAS Awards Software and Services Report, by Merge Cardio receiving the "Best in KLAS" honor in the cardiology category, by Merge Hemo maintaining its number one spot as KLAS Category Leader in cardiology hemodynamics for the third year in a row, by receipt of a Product Leadership Award from Frost & Sullivan for iConnect® Enterprise Clinical Platform and, for the second straight year, by being named the global leader in VNA according to IHS.

Business Segments

We operate under two reportable operating segments: Merge Healthcare and Merge DNA. Merge Healthcare represents about 83% of our 2013 total revenues and markets, sells and implements interoperability, imaging and clinical solutions to healthcare providers. Merge DNA (Data and Analytics) represents 17% of our 2013 total revenues and focuses on data capture software for clinical trials and other solutions. We evaluate the performance of each operating group based on their respective revenues and operating income. The performance evaluations exclude certain corporate costs, interest expense, amortization of debt issuance and discount costs and income taxes.

Merge Healthcare primarily generates revenue from the sale of software (including upgrades), hardware, professional services, maintenance and electronic data interchange (EDI) services. Today, the majority of total revenue continues to be generated through perpetual license agreements with our customers. Merge DNA derives the vast majority of its revenue from software, professional services, and hosting through subscription arrangements. Under perpetual license agreements, the software, hardware and professional services are considered to be sources of non-recurring revenue and related backlog. The backlog of non-recurring revenue was approximately $24.2 million and $31.2 million as of

December 31, 2013 and 2012, respectively. In January 2014, we revised our previously announced subscription backlog totals for the June 30, 2012 through September 30, 2013 quarters upon learning that a former sales employee in our eClinical business had falsified the existence or amount of certain customer contracts.

Subscription-based pricing arrangements include contract elements that are payable by our customers over a number of years. In 2013, subscription revenue was approximately 16% of total net sales. Generally, these contracts will include a minimum image volume and/or dollar commitment. As such, revenue from these transactions is recognized ratably over an extended period of time. Subscription arrangements include, but are not limited to, contracts that are structured with monthly payments (including leases), clinical trials or renewable annual software contracts (with very high renewal rates). As of December 31, 2013 subscription revenue backlog was $55.8 million, compared to $39.8 million at December 31, 2012. This significant increase is the result of our strategic plan to continue to move to a subscription based business model. Due to the variability in timing and length of maintenance renewals, we do not track backlog for maintenance and EDI.

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The following tables provide operating group information for the periods indicated, based on GAAP reported information.

Merge Healthcare Segment	Years Ended December 31,			Change 2013 vs. 2012	
	2013	2012	2011	$	%
Net sales:					
Software and other	$57,371	$78,941	$76,947	$(21,570)	-27.3 %
Professional Services	28,290	27,552	23,437	738	2.7 %
Maintenance and EDI	107,220	110,894	109,562	(3,674)	-3.3 %
Total net sales	192,881	217,387	209,946	(24,506)	-11.3 %
Expenses	171,838	192,408	166,898	(20,570)	-10.7 %
Segment income	$21,043	$24,979	$43,048	$(3,936)	-15.8 %

Merge DNA Segment	Years Ended December 31,			Change 2013 vs. 2012	
	2013	2012	2011	$	%
Net sales:					
Software and other	$21,204	$15,525	$4,001	$5,679	36.6 %
Professional Services	15,540	13,426	18,468	2,114	15.7 %
Maintenance and EDI	2,042	2,566	13	(524)	-20.4 %
Total net sales	38,786	31,517	22,482	7,269	23.1 %
Expenses	35,094	33,315	20,406	1,779	5.3 %
Segment income (loss)	$3,692	$(1,798)	$2,076	$5,490	-305.3%

The following tables provide GAAP sales generated by non-recurring, subscription and maintenance and EDI revenue sources by segment for 2013 and 2012 and non-recurring and subscription backlog as of December 31, 2013 and 2012. All amounts are in thousands, except percentages.

	Net Sales Year ended December 31, 2013					Backlog as of December 31, 2013				
	Healthcare		DNA			Healthcare		DNA		
Revenue Source	$	%	$	%	Total	$	%	$	%	Total
Maintenance & EDI (1)	$107,220	55.6 %	$2,042	5.3 %	47.2 %					
Subscription	7,063	3.7 %	29,951	77.2 %	16.0 %	$12,366	33.8 %	$43,453	100.0%	69.7 %
Non-recurring	78,598	40.7 %	6,793	17.5 %	36.8 %	24,234	66.2 %	-	0.0 %	30.3 %
Total	$192,881	100.0%	$38,786	100.0%	100.0%	$36,600	100.0%	$43,453	100.0%	100.0%
	83.3 %		16.7 %			45.7 %		54.3 %		

	Net Sales Year ended December 31, 2012					Backlog as of December 31, 2012				
	Healthcare		DNA			Healthcare		DNA		
Revenue Source	$	%	$	%	Total	$	%	$	%	Total
Maintenance & EDI (1)	$110,894	51.0 %	$2,566	8.1 %	45.6 %					
Subscription	11,581	5.3 %	26,247	83.3 %	15.2 %	$10,717	25.5 %	$29,108	100.0%	56.0 %

Non-recurring	94,912	43.7 %	2,704	8.6 %	39.2 %	31,243	74.5 %	-	0.0 %	44.0 %
Total	$217,387	100.0%	$31,517	100.0%	100.0%	$41,960	100.0%	$29,108	100.0%	100.0%
	87.3 %		12.7 %			59.0 %		41.0 %		

(1) Due to the variability in timing and length of maintenance renewals, we do not believe backlog for this revenue component is a meaningful disclosure.

Revenues and Expenses

The following is a brief discussion of our revenues and expenses:

Net Sales

Net sales consist of:

- Software and other sales, net of estimated returns and allowances, including our internally developed software, third party software and hardware revenue recognized in sales to OEM customers, healthcare facilities and other providers;

- Professional services, including hosting, installation, custom engineering services, training, consulting and project management; and

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- Maintenance and EDI, including software maintenance and support.

Cost of Sales

Cost of sales consists of:

- Software and other cost of sales, including purchased components and third-party royalties included in software and hardware sales to our customers;
- Professional services cost of sales, including headcount and related costs incurred in our performance of SaaS offerings, installation, custom engineering services, training, consulting and project management;
- Maintenance and EDI cost of sales, including headcount and related costs and direct third-party costs incurred to fulfill our maintenance and support obligations and to deliver EDI services; and
- Depreciation and amortization, including any impairment, for amounts assessed on capital equipment used to fulfill contract obligations as well as our purchased and developed software and backlog assets. Depreciation and amortization are recorded over the respective assets' useful lives. Each quarter we test our purchased and developed software for impairment by comparing its net realizable value (estimated using undiscounted future cash flows) to the carrying value of the software. If the carrying value of the software exceeds its net realizable value, we record an impairment charge in the period in which the impairment is incurred equal to the amount of the difference between the carrying value and estimated undiscounted future cash flows.

Sales and Marketing Expense

Sales and marketing expense includes the costs of our sales and marketing departments, commissions and costs associated with trade shows.

Research and Development Expense

Research and development expense consists of expenses incurred for the development of our proprietary software and technologies. The amortization of capitalized software development costs and any related impairments are included in cost of sales.

General and Administrative Expense

General and administrative expense includes costs for information systems, accounting, administrative support, management personnel, bad debt expense, legal fees and general corporate costs.

Acquisition-Related Expenses

Acquisition-related expenses are costs incurred to effect business combinations, including banking, legal, accounting, valuation and other professional or consulting fees.

Restructuring and Other Expenses

Restructuring and other expenses consist of severance to involuntarily terminated employees and relocation expenses resulting from our restructuring initiatives, loss on disposal of subsidiaries and impairment of non-cancelable building leases associated with restructuring activities.

Depreciation, Amortization and Impairment

Depreciation and amortization, including any impairment, are assessed on capital equipment, leasehold improvements and our customer relationships, trade names and non-compete agreement intangible assets. Depreciation and amortization are recorded over the respective assets' useful lives. We also record impairment of these long-lived assets whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable based primarily upon whether expected future undiscounted cash flows are sufficient to support recovery of the assets.

Loss on Debt Extinguishment

Loss on debt extinguishment includes charges for unamortized debt issuance costs, unamortized net debt discount and early retirement costs.

Other Income (Expense)

Other income (expense) is comprised of interest income earned on cash and cash equivalent balances, interest expense, amortization of costs and discounts incurred from borrowings and issuance costs on borrowings which did not qualify for capitalization. It also includes foreign exchange gains or losses on foreign currency payables and receivables. In addition, we also record any other-than-temporary impairment charges recognized on our equity investments in non-public companies in other income (expense).

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Results of Operations

The following have significantly impacted the results of operations for the periods discussed herein:

- In the second quarter of 2013, we entered into a new senior secured credit facility (Credit Agreement) consisting of a six-year term loan (the Term Loan) of $255 million issued at 99% of the Term Loan amount and a five-year revolving credit facility (the Revolving Credit Facility) of up to $20 million. While the interest on the borrowings under the credit facility is variable, we made an election pursuant to the Credit Agreement, with respect to the interest period, such that the Term Loan bore interest at a fixed rate of 6.00% during 2013. As part of this transaction, we incurred $4.6 million of debt issuance related costs, which will be amortized over the life of the Term Loan. The Term Loan replaces $252 million of Senior Secured Notes that bore interest at 11.75% (Notes), which we retired at the same time the Term Loan was funded. We recorded charges of $5.2 million for unamortized debt issuance costs, $1.7 million for unamortized net debt discount and $16.9 million of early retirement costs associated with the extinguishment for the Notes.

- In 2013, we completed certain restructuring initiatives. These initiatives included the end of life of specific, non-core products at low or negative margins, consolidations of operations surrounding three facilities and the reorganization of our leadership team and sales organization. As a result, we incurred $3.9 million of employee termination and contract exit costs that were recorded in restructuring and other expenses in our statement of operations.

- During the fourth quarter of 2012, we recorded charges of $3.9 million related to third party licenses and technology considered unusable, $1.3 million for the write-off of acquired intangibles and $9.2 million related primarily to uncollectible billings from customer contracts obtained through acquisitions in the past few years.

- We completed restructuring initiatives in September 2012 to reduce our workforce and in August 2011 concurrent with the acquisition of OIS. These initiatives assisted in providing operational rigor to a combined, larger organization and enabled us to decrease costs as a percentage of revenue (most notably general and administrative costs).

- We issued $200.0 million of Notes in April 2010 as part of the financing for the acquisition of AMICAS. We issued additional Notes in June 2011 to redeem and retire our Series A Preferred Stock (which had been issued as part of the financing for the acquisition of AMICAS). We issued these additional $52.0 million of Notes at 103.0% of the principal amount with terms identical to the Notes issued in April 2010. We used these proceeds to retire all 41,750 outstanding shares of our Series A Preferred Stock at the face value of $41.8 million and paid cumulative dividends of $7.3 million (which were accruing at a 15% annual compounded rate). The year ended December 31, 2012 includes twelve months of interest expense and amortization of the premium and certain issuance costs, whereas the year ended December 31, 2011 includes only seven months. Also, in the year ended December 31, 2011 we incurred $3.2 million in costs related to the issuance of the additional Notes, including $1.7 million which was expensed in “other expense, net” of our statement of operations and $1.5 million which was capitalized and amortized into interest expense over the then remaining term of the Notes.

Year Ended December 31, 2013 Compared to the Year Ended December 31, 2012

The following table sets forth selected, summarized, consolidated financial data for the periods indicated, as well as comparative data showing increases and decreases between the periods. All amounts, except percentages, are in thousands.

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	Years Ended December 31, 2013	% (1)	2012	% (1)	Change $	%
Net sales:						
Software and other	$78,575	33.9 %	$94,466	38.0 %	$(15,891)	-16.8%
Professional services	43,830	18.9 %	40,978	16.4 %	2,852	7.0 %
Maintenance and EDI	109,262	47.2 %	113,460	45.6 %	(4,198)	-3.7 %
Total net sales	231,667	100.0%	248,904	100.0%	(17,237)	-6.9 %
Cost of sales:						
Software and other	41,813	53.2 %	43,281	45.8 %	(1,468)	-3.4 %
Professional services	25,114	57.3 %	24,693	60.3 %	421	1.7 %
Maintenance and EDI	28,989	26.5 %	31,090	27.4 %	(2,101)	-6.8 %
Depreciation, amortization and impairment	6,980	3.0 %	8,987	3.6 %	(2,007)	-22.3%
Total cost of sales	102,896	44.4 %	108,051	43.4 %	(5,155)	-4.8 %
Total gross margin	128,771	55.6 %	140,853	56.6 %	(12,082)	-8.6 %
Gross margin by net sales category (2)						
Software and other	36,762	46.8 %	51,185	54.2 %	(14,423)	-28.2%
Professional services	18,716	42.7 %	16,285	39.7 %	2,431	14.9 %
Maintenance and EDI	80,273	73.5 %	82,370	72.6 %	(2,097)	-2.5 %
Operating expenses:						
Sales and marketing	36,585	15.8 %	43,908	17.6 %	(7,323)	-16.7%
Product research and development	32,388	14.0 %	32,419	13.0 %	(31)	-0.1 %
General and administrative	34,689	15.0 %	42,366	17.0 %	(7,677)	-18.1%
Acquisition-related expenses	906	0.4 %	3,402	1.4 %	(2,496)	-73.4%
Restructuring and other expenses	3,856	1.7 %	830	0.3 %	3,026	NM
Depreciation, amortization and impairment	10,540	4.5 %	11,308	4.5 %	(768)	-6.8 %
Total operating costs and expenses	118,964	51.4 %	134,233	53.9 %	(15,269)	-11.4%
Operating income (loss)	9,807	4.2 %	6,620	2.7 %	3,187	48.1 %
Loss on debt extinguishment	(23,822)	-10.3 %	-	0.0 %	(23,822)	NM
Other expense, net	(22,079)	-9.5 %	(31,349)	-12.6 %	9,270	-29.6%
Loss before income taxes	(36,094)	-15.6 %	(24,729)	-9.9 %	(11,365)	46.0 %(3)
Income tax expense	2,889	1.2 %	4,091	1.6 %	(1,202)	-29.4%
Net loss	$(38,983)	-16.8 %	$(28,820)	-11.6 %	$(10,163)	35.3 %(3)

(1) Percentages are of total net sales, except for cost of sales and gross margin, which are based upon related net sales.
(2) Depreciation, amortization and impairment expenses are excluded from these gross margin calculations.
(3) NM denotes percentage is not meaningful.

Net Sales

Software and Other Sales. Total software and other sales in 2013 were $78.6 million, a decrease of $15.9 million, or 16.8% from $94.5 million in 2012. Software and other sales decreased $21.6 million in the Healthcare segment, primarily due to the customer buying delays we experienced as a result of the previously discussed change in market conditions in 2013. Software and other sales increased $5.7 million in the DNA segment, primarily due to the sale of digital kiosks in 2013 for $3.1 million more than the prior year, as we exited this low margin product line, and increased clinical trials bookings which drove the remainder of the increase. Software and hardware orders sold through perpetual software agreements in the Healthcare segment are typically fulfilled, and revenue recognized, in either the quarter signed or the following few quarters. Revenue recognized from software and other sales may vary significantly on a quarterly basis.

Professional Services Sales. Total professional services sales in 2013 were $43.8 million, an increase of $2.8 million, or 7.0% from $41.0 million in 2012. Professional services sales in our Healthcare segment increased $0.7 million as a direct result of the increase in overall perpetual software license agreements. Professional services sales in our DNA segment increased $2.1 million, primarily due to increased clinical trials sales. Revenue recognized from professional services sales generally lag software and other sales by one to three quarters due to the timing of when such services are performed compared to when the products are delivered.

Maintenance and EDI Sales. Total maintenance and EDI sales in 2013 were $109.3 million, a decrease of $4.2 million, or 3.7%, from $113.5 million in 2012. The decrease is primarily due to a decrease in software maintenance support sales as we exited unprofitable product lines (see restructuring and other expenses discussion).

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Gross Margin

Gross Margin – Software and Other Sales. Gross margin on software and other sales was $36.8 million in 2013, a decrease of $14.4 million, or 28.2%, from $51.2 million in 2012. Gross margin as a percentage of software and other sales decreased to 46.8% in 2013 from 54.2% in 2012, due to a decrease in software sales which produce a much greater margin than do hardware sales. Hardware sales were 48.0% of software and other sales in 2013 compared to 40.0% in 2012, primarily due to the aforementioned kiosk sales. We expect gross margins on software and other sales to fluctuate depending on the software and hardware mix.

Gross Margin – Professional Services Sales. Gross margin on professional service sales was $18.7 million in 2013, an increase of $2.4 million, or 14.9%, from $16.3 million in 2012. Gross margin as a percentage of professional service sales increased to 42.7% in 2013 from 39.7% in 2012, primarily due to the billable utilization of our professional services resources. As the majority of professional services costs are fixed, we expect gross margins to fluctuate depending on billable utilization of these resources.

Gross Margin – Maintenance and EDI Sales. Gross margin on maintenance and EDI sales was $80.3 million in 2013, a decrease of $2.1 million, or 2.5%, from $82.4 million in 2012. Gross margin as a percentage of maintenance and EDI sales increased to 73.5% in 2013 compared to 72.6% in 2012, as we continue to focus on controlling third party costs.

Depreciation, Amortization and Impairment

Depreciation, amortization and impairment decreased $2.0 million, or 22.3%, to $7.0 million in 2013 from $9.0 million in 2012, primarily due to a decrease in amortization related to certain acquired intangible assets which were written off in 2012, including the related $0.8 million charge for the write-off of those acquired intangibles in 2012.

Sales and Marketing

Sales and marketing expense decreased $7.3 million, or 16.7%, to $36.6 million in 2013 from $43.9 million in 2012. As a percentage of net sales, sales and marketing decreased by 1.8%, to 15.8%, primarily due to the restructuring activity undertaken in the third quarter of 2013.

Product Research and Development

Product research and development expense in 2013 was flat when compared to 2012. As a percentage of net sales, product research and development increased to 14.0% in 2013 compared to 13.0% in 2012as we continued to invest in both new product innovation and enhancement of our existing solutions.

General and Administrative

General and administrative expense decreased $7.7 million, or 18.1%, to $34.7 million in 2013 from $42.4 million in 2012. Offsetting factors caused this change and include a reduction in bad debt expense of $7.0 million, a favorable non-cash settlement of $2.5 million in 2013 (for which significant legal costs were incurred in prior periods) and the negative impacts from a $1.3 million non-cash charge relating to the settlement involving an insignificant acquisition and a $0.9 million non-cash charge associated with stock consideration provided for in the settlement of a lawsuit that existed at the time of an insignificant acquisition.

Acquisition-Related Expenses

Acquisition-related expenses are costs incurred to effect business combinations, including banking, legal, accounting, valuation and other professional or consulting fees. Acquisition-related expenses decreased $2.5 million in 2013 to

$0.9 million, from $3.4 million in 2012 primarily due to reduced activities in the year.

Restructuring and other expenses

We incurred $3.9 million and $0.8 million of employee termination and contract exit costs that were recorded in restructuring and other expenses in our statement of operations in 2013 and 2012, respectively, as a result of the previously discussed initiatives in each year.

Depreciation, Amortization and Impairment

Depreciation, amortization and impairment expense decreased $0.8 million, or 6.8%, to $10.5 million in 2013 from $11.3 million in 2012.

Loss on Debt Extinguishment

During the second quarter of 2013, we recorded a charge of $23.8 million for the early extinguishment of our Notes. This charge consisted of $5.2 million for unamortized debt issuance costs, $1.7 million for unamortized net debt discount and $16.9 million for early retirement costs.

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Other Expense, net

Other expense, net decreased $9.2 million to $22.1 million in 2013 compared to $31.3 million in 2012. The decrease is primarily due to debt refinancing activities that resulted in a lower interest rate and $11.2 million less expense in 2013. Other expense, net included a $0.6 million realized loss on an equity investment in 2013, while 2012 included a $0.5 million gain on the same equity security investment as well as a favorable legal settlement of $0.3 million.

Income Tax Expense

In 2013, we recorded income tax expense of $2.9 million on a pre-tax book loss of $36.1 million, resulting in a negative annual effective tax rate of 8.0% compared to a $4.1 million tax expense in 2012 and a negative effective tax rate of 16.5% The tax expense in each year resulted from profitable Canadian operations (which was greater in 2012), state income taxes, and the deferred effect of tax deductible goodwill amortization. Only the state income taxes resulted in cash tax payments. Our expected effective income tax rate is volatile and may move up or down with changes in, among other items, operating income and the results of changes in tax law and regulations of the U. S. and the foreign jurisdictions in which we operate.

Year Ended December 31, 2012 Compared to the Year Ended December 31, 2011

The following table sets forth selected, summarized, consolidated financial data for the periods indicated, as well as comparative data showing increases and decreases between the periods. All amounts, except percentages, are in thousands.

	Years Ended December 31,				Change	
	2012	% (1)	2011	% (1)	$	%
Net sales:						
Software and other	$94,466	38.0 %	$80,948	34.8 %	$13,518	16.7 %
Professional services	40,978	16.4 %	41,905	18.0 %	(927)	-2.2 %
Maintenance and EDI	113,460	45.6 %	109,575	47.2 %	3,885	3.5 %
Total net sales	248,904	100.0%	232,428	100.0%	16,476	7.1 %
Cost of sales:						
Software and other	43,281	45.8 %	29,090	35.9 %	14,191	48.8 %
Professional services	24,693	60.3 %	21,134	50.4 %	3,559	16.8 %
Maintenance and EDI	31,090	27.4 %	29,090	26.5 %	2,000	6.9 %
Depreciation, amortization and impairment	8,987	3.6 %	9,340	4.0 %	(353)	-3.8 %
Total cost of sales	108,051	43.4 %	88,654	38.1 %	19,397	21.9 %
Total gross margin	140,853	56.6 %	143,774	61.9 %	(2,921)	-2.0 %
Gross margin by net sales category (2)						
Software and other	51,185	54.2 %	51,858	64.1 %	(673)	-1.3 %
Professional services	16,285	39.7 %	20,771	49.6 %	(4,486)	-21.6 %
Maintenance and EDI	82,370	72.6 %	80,485	73.5 %	1,885	2.3 %
Operating expenses:						
Sales and marketing	43,908	17.6 %	38,800	16.7 %	5,108	13.2 %
Product research and development	32,419	13.0 %	27,542	11.8 %	4,877	17.7 %
General and administrative	42,366	17.0 %	32,579	14.0 %	9,787	30.0 %
Acquisition-related expenses	3,402	1.4 %	1,614	0.7 %	1,788	110.8%
Restructuring and other expenses	830	0.3 %	1,216	0.5 %	(386)	-31.7 %

Depreciation, amortization and impairment	11,308	4.5 %	12,868	5.5 %	(1,560)	-12.1 %
Total operating costs and expenses	134,233	53.9 %	114,619	49.3 %	19,614	17.1 %
Operating income (loss)	6,620	2.7 %	29,155	12.5 %	(22,535)	-77.3 %
Other expense, net	(31,349)	-12.6 %	(31,021)	-13.3 %	(328)	1.1 %
Loss before income taxes	(24,729)	-9.9 %	(1,866)	-0.8 %	(22,863)	NM (3)
Income tax expense	4,091	1.6 %	3,665	1.6 %	426	11.6 %
Net loss	$(28,820)	-11.6 %	$(5,531)	-2.4 %	$(23,289)	NM (3)

(1) Percentages are of total net sales, except for cost of sales and gross margin, which are based upon related net sales.
(2) Depreciation, amortization and impairment expenses are excluded from these gross margin calculations.
(3) NM denotes percentage is not meaningful.

Net Sales

Software and Other Sales. Total software and other sales in 2012 were $94.5 million, an increase of $13.5 million, or 16.7%, from $80.9 million in 2011. Software and other sales increased $11.5 million in the DNA segment, primarily due to $9.1 million in sales and rentals of kiosks as well as an increase in clinical trials software sales of $2.4 million. Software and other sales also increased $2.0 million in the Healthcare segment, primarily due to an increase in our interoperability solution, which was introduced in January 2011. Software and hardware orders sold through perpetual software agreements in the Healthcare segment are typically fulfilled, and revenue recognized, in either the quarter signed or the following two quarters. Revenue recognized from software and other sales may vary significantly on a quarterly basis.

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Professional Services Sales. Total professional services sales in 2012 were $41.0 million, a decrease of $0.9 million, or 2.2%, from $41.9 million in 2011. Professional services sales in our Healthcare segment increased $4.1 million, primarily due to a greater number of projects in 2012 compared to 2011. This increase was offset by a decrease of $5.0 million in our DNA segment, primarily due to an enhancement to the clinical trial platform that resulted in less professional services being required. Revenue recognized from professional services sales generally lag software and other sales by one or three quarters due to the timing of when such services are performed compared to when the products are delivered.

Maintenance and EDI Sales. Total maintenance and EDI sales in 2012 were $113.5 million, an increase of $3.9 million, or 3.5%, from $109.6 million in 2011 primarily due to maintenance revenue related to new contracts which exceeded the rate of attrition from our existing maintenance customer base.

Gross Margin

Gross Margin – Software and Other Sales. Gross margin on software and other sales was $51.2 million in 2012, a decrease of $0.7 million, or 1.3%, from $51.9 million in 2011. Gross margin as a percentage of software and other sales decreased to 54.2% in 2012 from 64.1% in 2011, due to $2.0 million related to third party licenses and $1.9 million in technology considered unusable and an increase in hardware sales, which are at lower margins than those involving software only. Hardware sales were 40.0% of software and other sales in 2012 compared to 32.0% in 2011, primarily due to the kiosk sales. We expect gross margins on software and other sales to fluctuate depending on the software and hardware mix.

Gross Margin – Professional Services Sales. Gross margin on professional service sales was $16.3 million in 2012, a decrease of $4.5 million, or 21.6%, from $20.8 million in 2011. Gross margin as a percentage of professional service sales decreased to 39.7% in 2012 from 49.6% in 2011, primarily due to the billable utilization of our professional services resources. As the majority of professional services costs are fixed, we expect gross margins to fluctuate depending on billable utilization of these resources.

Gross Margin – Maintenance and EDI Sales. Gross margin on maintenance and EDI sales was $82.4 million in 2012, an increase of $1.9 million, or 2.3%, from $80.5 million in 2011. Gross margin as a percentage of maintenance and EDI sales increased to 72.6% in 2012 compared to 73.5% in 2011, primarily due to an increase in third party maintenance costs.

Depreciation, Amortization and Impairment

Depreciation, amortization and impairment decreased $0.3 million, or 3.8%, to $8.9 million in 2012 from $9.3 million in 2011, primarily due to a decrease in amortization related to certain intangible assets which became fully amortized in 2011 offset by $0.8 million for the write-off of acquired intangibles in 2012.

Sales and Marketing

Sales and marketing expense increased $5.1 million, or 13.2%, to $43.9 million in 2012 from $38.8 million in 2011. As a percentage of net sales, sales and marketing increased by 0.9% to 17.6% due to increased branding efforts, customer facing events and personnel investments in these functions.

Product Research and Development

Product research and development expense increased $4.9 million, or 17.7%, to $32.4 million in 2012 from $27.5 million in 2011, primarily due to an increase of $2.7 million in headcount and related expenses and $2.2 million for professional fees. As a percentage of net sales, product research and development increased to 13.0% in 2012 compared to 11.8% in 2011.

General and Administrative

General and administrative expense increased $9.8 million, or 30.0%, to $42.4 million in 2012 from $32.6 million in 2011, due to an increase of $9.1 million related to bad debt expense primarily due to our reserve for revenue in excess of billings and uncollectible billings from customer contracts obtained through acquisitions in the past few years, an increase of $2.4 million related to increased headcount, offset by a decrease in charitable contributions of $1.9 million.

Acquisition-Related Expenses

Acquisition-related expenses are costs incurred to effect business combinations, including banking, legal, accounting, valuation and other professional or consulting fees. Acquisition-related expenses increased $1.8 million in 2012 to $3.4 million, from $1.6 million in 2011 primarily due to $1.6 million in contingent consideration paid for an insignificant acquisition.

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Restructuring and other expenses

Restructuring and other expenses consist primarily of severance to involuntarily terminated employees and relocation of certain employees resulting from our restructuring initiatives and abandonment of non-cancelable building leases associated with restructuring activities. In 2012, we incurred $0.8 million of such expenses primarily related to the initiative that commenced in September of 2012. In 2011, we incurred $1.2 million of such expenses, primarily related to the reorganization of our business concurrent with the acquisition of OIS.

Depreciation, Amortization and Impairment

Depreciation, amortization and impairment expense decreased $1.6 million, or 12.1%, to $11.3 million in 2012 from $12.9 million in 2011. Upon completion of a product rationalization and a product being rebranded in the fourth quarter of 2012, we recorded a $0.5 million charge to trade names. Upon completion of a product rebranding initiative in the second quarter of 2011, we recorded a $2.9 million charge due to the impairment of our trade names associated with certain products. This decrease was offset by a $0.7 million increase due to prior year acquisitions.

Other expense, net

Net other expense increased $0.3 million to $31.3 million in 2012 compared to $31.0 million in 2011. Interest expense increased $3.5 million primarily due to the $52.0 million of debt issued in June 2011 being outstanding for all of 2012 compared to a portion of 2011. The increase in interest expense is offset by increased interest income of $0.3 million in 2012 over 2011, $1.6 million of debt refinancing costs in 2011 with no corresponding charge in 2012, a $0.5 million gain on equity security investment in 2012 and a favorable legal settlement of $0.3 million in 2012.

Income Tax Expense

In 2012, we recorded income tax expense of $4.1 million on a pre-tax book loss of $24.7 million, resulting in a negative annual effective tax rate of 16.5% compared to a $3.7 million tax expense in 2011. The tax expense in 2012 resulted from profitable Canadian operations, state income taxes, and the deferred effect of tax deductible goodwill amortization. Only the state income taxes resulted in cash tax payments. Our expected effective income tax rate is volatile and may move up or down with changes in, among other items, operating income and the results of changes in tax law and regulations of the U. S. and the foreign jurisdictions in which we operate.

Liquidity and Capital Resources

Our cash and cash equivalents were $19.7 million at December 31, 2013, a decrease of approximately $16.2 million, or 45.1%, from our balance of $35.9 million at December 31, 2012. This decrease is primarily the result of using $21.5 million of cash to complete the refinancing of our debt (excluding interest) during the second quarter and the use of $15.0 million to make voluntary principal payments under the Credit Agreement. In addition to the aforementioned change in cash, the working capital decrease is primarily due to a $10.2 million decrease of accounts receivable and $6.7 million decrease in the revenue in excess of billings account within other current assets as a result of significant strides in the timeliness of both billing and collection activities in 2013. In connection with the Credit Agreement, we entered into a five-year revolving credit facility of up to $20.0 million, which we may use for working capital and for general corporate purposes, but have not yet drawn upon.

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The net change in cash and cash equivalents (including restricted cash) is attributed to the following factors:

	Year Ended December 31,		
	2013	2012	2011
	(in millions)		
Cash received from (paid for):			
Issuance of debt, net of OID of $2.5 and equity	$252.5	$-	$53.6
Retirement of debt, including prepayment penalty of $16.9	(268.9)	-	-
Principal payments on notes	(16.3)	-	(4.6)
Interest paid, net	(24.8)	(29.7)	(25.7)
Debt and equity issuance costs	(4.6)	-	(3.2)
Redemption of preferred stock	-	-	(41.8)
Payment of preferred stock dividends	-	-	(7.3)
Proceeds from stock option exercises	1.2	0.7	-
Acquisitions, net of cash acquired	-	(0.9)	(2.9)
Restructuring initiatives	(2.8)	(1.5)	(1.9)
Acquisition related expenses	(1.1)	(1.0)	(1.8)
Sale of investment	1.8	-	-
Property and equipment purchases	(2.2)	(2.2)	(1.9)
Purchased technology	(0.5)	-	-
Capitalized software development	(0.1)	-	-
Settlements with former officers	-	-	(0.9)
Other non-operating cash flows	-	-	0.4
Business operations	49.6	31.3	36.2
Decrease in cash, including restricted cash	$(16.2)	$(3.3)	$(1.8)

Operating Cash Flows

As set forth in the statement of cash flows included in our audited financial statements, cash provided by operating activities was $21.3 million in 2013, compared to cash used in operating activities of $0.7 million in 2012. The net loss in 2013 of $39.0 million includes non-cash expenses of $51.3 million. We incurred $24.8 million in interest expense on our $252.0 million of extinguished Notes as well as the applicable portion of the quarterly interest payments under our new Term Loan (which is due on the last day of each calendar quarter). Additionally, $2.8 million was paid related to restructuring activities during 2013 with $1.3 million remaining to be paid in future periods.

Average quarterly DSO in 2013 was 106 days compared to a quarterly average of 103 days in 2012.

Investing Cash Flows

Cash used in investing activities was $0.6 million in 2013, compared to cash used in investing activities of $3.4 million in 2012. In 2013, we purchased $2.8 million in fixed assets and acquired technology, and incurred a $0.4 million decrease in restricted cash. In 2012, we paid $0.9 million, net of cash acquired, for insignificant acquisitions, purchased $2.2 million in fixed assets, and incurred a $0.1 million increase in restricted cash.

Financing Cash Flows

Cash used in financing activities was $36.3 million in 2013, compared to cash provided by financing activities of $0.6 million in 2012. The change of $36.9 million is primarily due to debt refinancing which consisted of a $16.9 million penalty for early extinguishment of debt and debt issuance costs of $4.6 million. Additionally, required minimum Term Loan principal payments of $1.3 million and voluntary principal payments of $15.0 million were made during the year ended December 31, 2013. In the years ended December 31, 2013, 2012 and 2011, we also received $1.5 million, $1.0 million and $1.2 million, respectively in proceeds from the exercise of stock options and shares purchased under the employee stock purchase plan.

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Contractual Obligations

Total outstanding commitments as of December 31, 2013 (in thousands), were as follows:

		Payment due by period			
Contractual Obligations	Total	Less than 1 Year	1 – 3 Years	3 – 5 Years	More than 5 Years
Operating leases	$14,722	$2,313	$3,911	$2,764	$5,734
Capital leases (including interest)	989	712	277	-	-
Acquisition obligations	2,240	1,967	273	-	-
Term loan (including interest)	314,682	16,955	33,456	32,850	231,421
Patent license obligation	1,250	125	250	250	625
Other notes payable (including interest)	38	15	23	-	-
Total	$333,921	$22,087	$38,190	$35,864	$237,780

The above obligations include lease payments involving facilities that we have either ceased to use or previously abandoned.

We do not have any other significant long-term obligations, contractual obligations, lines of credit, standby letters of credit, guarantees, standby repurchase obligations or other commercial commitments except for the contractual obligations shown above and restricted cash of $0.4 million (primarily letters-of-credit related to our leased facilities) at December 31, 2013.

As of December 31, 2013, approximately $1.1 million of our cash balance was held by our foreign subsidiaries. We may need to accrue and pay taxes if we choose to repatriate these funds.

General

We believe our current cash and cash equivalent balances will be sufficient to meet our operating, financing and capital requirements through at least the next 12 months, including minimum principal and interest payments due under the Term Loan. However, any projections of future cash inflows and outflows are subject to uncertainty. In the event that it is necessary to raise additional capital to meet our short term or long term liquidity needs, such capital may be raised through additional debt, equity offerings or sale of certain assets, however our ability to undertake such transactions may be limited by the Credit Agreement. If we raise additional funds through the issuance of equity, equity-related or debt securities, such securities may have rights, preferences or privileges senior to those of our common stock. Furthermore, the number of shares of any new equity or equity-related securities that may be issued may result in significant dilution to existing shareholders. In addition, the issuance of debt securities could increase the liquidity risk or perceived liquidity risk that we face. We cannot, however, be certain that additional financing, or funds from asset sales, will be available on acceptable terms. If adequate funds are not available or are not available on acceptable terms, we will likely not be able to take advantage of opportunities, develop or enhance services or products or respond to competitive pressures. In particular, our uses of cash in 2014 and beyond will depend on a variety of factors such as the costs to implement our business strategy, the amount of cash that we are required to devote to defend and address any legal or regulatory proceedings, and potential merger and acquisition activities. Liquidity on a go forward basis is dependent on our ability to meet covenants in our Credit Agreement, including our financial covenants, in particular a debt-to-adjusted-EBITDA ratio with a maximum allowance of 5.5 : 1 as of December 31, 2013. As of December 31, 2013, our debt-to-adjusted EBITDA ratio was 5.3 : 1. For a description of the other covenants included in our Credit Agreement, see Note 6 of the notes to consolidated financial statements included in this Annual Report on Form 10-K.

Material Off Balance Sheet Arrangements

We have no material off balance sheet arrangements.

Critical Accounting Policies

Our consolidated financial statements are impacted by the accounting policies used and the estimates, judgments, and assumptions made by management during their preparation. We base our estimates and judgments on our experience, our current knowledge (including terms of existing contracts), our beliefs of what could occur in the future, our observation of trends in the industry, information provided by our customers and information available from other sources. Actual results may differ from these estimates under different assumptions or conditions.

We have identified the following accounting policies and estimates as those that we believe are most critical to our financial condition and results of operations and that require management's most subjective and complex judgments in estimating the effect of inherent uncertainties: revenue recognition, allowance for doubtful accounts and sales returns, intangible assets and goodwill, share-based compensation expense, income taxes, guarantees and loss contingencies.

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Revenue Recognition

Revenues are derived primarily from the licensing of software, sales of hardware and related ancillary products, SaaS offerings, installation and engineering services, training, consulting, and software maintenance and EDI. Inherent to software revenue recognition are significant management estimates and judgments in the interpretation and practical application of the complex rules to individual contracts. These interpretations generally would not influence the amount of revenue recognized, but could influence the timing of such revenues. In addition, 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. Significant areas of judgment include:

- The determination of deliverables specified in a multiple-element arrangement and treatment as separate units of accounting;

- Whether separate arrangements with the same customer executed within a short time frame of each other are a single arrangement;

- The assessment of the probability of collection and the current credit worthiness of each customer since we generally do not request collateral from customers;

- The determination of whether the fees are fixed and determinable;

- Whether or not installation, engineering or consulting services are significant to the software licensed; and

- The amount of total estimated labor hours, based on management's best estimate, to complete a project we account for under the input method of percentage of completion accounting. We review our contract estimates periodically to assess revisions in contract values and estimated labor hours, and reflect changes in estimates in the period that such estimates are revised under the cumulative catch-up method.

Typically, our contracts contain multiple elements, and while the majority of our contracts contain standard terms and conditions, there are instances where our contracts contain non-standard terms and conditions. As a result, contract interpretation is sometimes required to determine the appropriate accounting. We analyze our multiple element arrangements to determine the estimated selling price 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.

Allowance for Doubtful Accounts and Sales Returns

Based upon past experience and judgment, we establish allowances for doubtful accounts related to our accounts receivable and customer credits with respect to our sales returns. We determine collection risk and record allowances for bad debts based on the aging of accounts and past transaction history with customers. In addition, our policy is to allow sales returns when we have preauthorized the return. We have determined an allowance for estimated returns and credits based on our historical experience of returns and customer credits. We monitor our collections, write-offs, returns and credit experience to assess whether adjustments to our allowance estimates are necessary. Changes in trends in any of the factors that we believe impact the realizability of our receivables or modifications to our credit standards, collection, return and credit, authorization practices or other related policies may impact our estimates.

Intangible Assets and Goodwill

Intangible assets include purchased software, capitalized software, customer relationships, backlog, trade names, and non-compete agreements. Finite-lived intangible assets are amortized to reflect the pattern in which the economic benefits are consumed, which is primarily the straight-line method.

Purchased software and capitalized software are tested for impairment quarterly by comparing the net realizable value (estimated using undiscounted future cash flows) to the carrying value of the software. If the carrying value of the software exceeds its net realizable value, we record an impairment charge in the period in which the impairment is incurred equal to the amount of the difference between the carrying value and estimated undiscounted future cash flows.

Customer relationships, backlog, trade names and non-compete agreements are evaluated for potential impairment whenever events or circumstances indicate that the carrying amount may not be recoverable, based primarily upon whether expected future undiscounted cash flows are sufficient to support the asset's recovery. If the actual useful life of the asset is shorter than the useful life estimated by us, the asset may be deemed to be impaired, and, accordingly, a write-down of the value of the asset determined by a discounted cash flow analysis, or a shorter amortization period, may be required. We have reviewed these long-lived assets with estimable useful lives and determined that their carrying values as of December 31, 2013 are recoverable in future periods.

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We review goodwill for impairment annually or more frequently if impairment indicators arise. Our policy provides that goodwill will be reviewed for impairment as of October 1st of each year. In calculating potential impairment losses, we evaluate the fair value of our reporting units using either quoted market prices or, if not available, by estimating the expected present value of their future cash flows. We use a two-step impairment test. 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. If the fair value of a reporting unit exceeds its carrying amount, goodwill of the reporting unit is considered not impaired, thus the second step of the impairment test is unnecessary. If the carrying amount of a reporting unit exceeds its fair 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 reporting unit goodwill with the carrying amount of that goodwill. If the carrying amount of reporting unit's goodwill exceeds the implied fair value of that goodwill, an impairment loss is recognized in an amount equal to that excess.

Identification of, and assignment of assets and liabilities to, a reporting unit require our judgment and estimates. In addition, future cash flows are based upon our assumptions about future sales activity and market acceptance of our products. If these assumptions change, we may be required to write down the gross value of our remaining goodwill to a revised amount. We performed our goodwill testing and determined that there is no impairment as of December 31, 2013, since the fair value of our reporting units substantially exceeded the carrying value.

Share-based Compensation Expense

We calculate share-based compensation expense for option awards based on the estimated grant-date fair value using the Black-Scholes option pricing model, and recognize the expense on a straight-line basis over the vesting period, net of estimated forfeitures. The fair value of stock-based awards is based on certain assumptions, including:

- Expected volatility, which we base on the historical volatility of our stock and other factors; and
- Estimated option life, which represents the period of time the options granted are expected to be outstanding and is based, in part, on historical data.

We also estimate employee terminations (option forfeiture rate), which is based, in part, on historical data, employee class and the type of award. We evaluate the assumptions used to value stock options and restricted stock awards on a quarterly basis. The estimation of share-based awards that will ultimately vest requires judgment, and to the extent actual results or updated estimates differ from our current estimates, such amounts will be recorded as a cumulative adjustment in the period estimates are revised. Although we believe our assumptions used to calculate share-based compensation expense are reasonable, these assumptions can involve complex judgments about future events, which are open to interpretation and inherent uncertainty. In addition, significant changes to our assumptions could significantly impact the amount of expense recorded in a given period.

Income Taxes

As part of the process of preparing our consolidated financial statements, we are required to estimate income taxes in each of the jurisdictions in which we operate. Our provision for income taxes is determined using the asset and liability approach to account for income taxes. A current liability is recorded for the estimated taxes payable for the current year. Deferred tax assets and liabilities are recorded for the estimated future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using the enacted tax rates in effect for the year in which the timing differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of changes in tax rates or tax laws are recognized in the provision for income taxes in the period that includes the enactment date.

Valuation allowances are established, when necessary, to reduce deferred tax assets to the amount more-likely-than-not to be realized. Changes in valuation allowances will flow through the statement of operations unless related to deferred tax assets that expire unutilized or are modified through translation, in which case both the deferred tax asset and related valuation allowance are similarly adjusted. Where a valuation allowance was established through purchase accounting for acquired deferred tax assets, any future change will be credited or charged to income tax expense.

The determination of our provision for income taxes requires significant judgment, the use of estimates, and the interpretation and application of complex tax laws. We are subject to income taxes in the U.S. and numerous foreign jurisdictions. Significant judgment is required in determining our worldwide provision for income taxes and recording the related tax assets and liabilities. In the ordinary course of our business, there are transactions and calculations for which the ultimate tax determination is uncertain. In spite of our belief that we have appropriate support for all the positions taken on our tax returns, we acknowledge that certain positions may be successfully challenged by the taxing authorities. We determine the tax benefits more likely than not to be recognized with respect to uncertain tax positions. Unrecognized tax benefits are evaluated quarterly and adjusted based upon new information, resolution with taxing authorities and expiration of the statute of limitations. The provision for income taxes includes the impact of changes in the liability for our uncertain tax positions. Although we believe our recorded tax assets and liabilities are reasonable, tax laws and regulations are subject to interpretation and inherent uncertainty; therefore, our assessments can involve both a series of complex judgments about future events and rely on estimates and assumptions. Although we believe these estimates and assumptions are reasonable, the final determination could be materially different than that which is reflected in our provision for income taxes and recorded tax assets and liabilities.

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Guarantees

We recognize the importance of identifying the fair value of guarantee and indemnification arrangements issued or modified by us, as applicable. In addition, we must continue to monitor the conditions that are subject to the guarantees and indemnifications in order to identify if a loss has occurred. If we determine it is probable that a loss has occurred, then any such estimable loss would be recognized under those guarantees and indemnifications.

Under our standard software license agreements, we agree to indemnify, defend and hold harmless our licensees from and against certain losses, damages and costs arising from claims alleging the licensees' use of our software infringes the intellectual property rights of a third party. Historically, we have not been required to pay material amounts in connection with claims asserted under these provisions, and, accordingly, we have not recorded a liability relating to such provisions. We also represent and warrant to licensees that our software products will operate substantially in accordance with published specifications, and that the services we perform will be undertaken by qualified personnel in a professional manner conforming to generally accepted industry standards and practices. Historically, only minimal costs have been incurred relating to the satisfaction of product warranty claims.

Other guarantees include promises to indemnify, defend and hold harmless each of our executive officers, non-employee directors and certain key employees from and against losses, damages and costs incurred by each such individual in administrative, legal or investigative proceedings arising from alleged wrongdoing by the individual while acting in good faith within the scope of his or her job duties on our behalf.

Loss Contingencies

We have accrued for costs as of December 31, 2013 and may, in the future, accrue for costs associated with certain contingencies when such costs are probable and reasonably estimable. Liabilities established to provide for contingencies are adjusted as further information develops, circumstances change, or contingencies are resolved.

Recent Accounting Pronouncements

We describe below recent pronouncements that have had or may have a significant effect on our financial statements or have an effect on our disclosures. We do not discuss recent pronouncements that are not anticipated to have an impact on or are unrelated to our financial condition, statement of operations, or related disclosures.

In February 2013, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2013-02, Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income, which is included in ASC Topic 220 (Comprehensive Income). The objective of ASU 2013-02 is to improve the reporting of reclassifications out of accumulated other comprehensive income. The amendments are effective prospectively for reporting periods beginning after December 15, 2012. We have implemented this amendment and included the required disclosure in the Notes to the Consolidated Financial Statements.

In July 2013, the FASB issued ASU No. 2013-11, Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exist, which is included in ASC Topic 740 (Income Taxes). ASU 2013-11 requires an entity to net its liability for unrecognized tax positions against a net operating loss carryforward, a similar tax loss or a tax credit carryforward when settlement in this manner is available under the tax law. The provisions of this new guidance are effective for reporting periods beginning after December 15, 2013. The guidance is not expected to have a material impact on our statement of operations, financial position, or cash flows.

In October 2012, the FASB issued ASU No. 2012-04, Technical Corrections and Improvements. The amendments in this update cover a wide range of Topics in the Accounting Standards Codification. These amendments include technical corrections and improvements to the Accounting Standards Codification and conforming amendments related to fair value measurements. The amendments in this update will be effective for fiscal periods beginning after December 15, 2012. The adoption of ASU No. 2012-014 did not have a material impact on our statement of operations, financial position or cash flows.

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In August 2012, the FASB issued ASU No. 2012-03, Technical Amendments and Corrections to SEC Sections: Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin (SAB) No. 114, Technical Amendments Pursuant to SEC Release No. 33-9250, and Corrections Related to FASB Accounting Standards Update No. 2010-22 (SEC Update). This update amends various SEC paragraphs pursuant to the issuance of SAB No. 114. The adoption of ASU No. 2012-03 did not have a material impact on our statement of operations, financial position, or cash flows.

In July 2012, the FASB issued ASU No. 2012-02, Intangibles — Goodwill and Other — Testing Indefinite-Lived Intangible Assets for Impairment, to establish an optional two-step analysis for impairment testing of indefinite-lived intangibles other than goodwill. The two-step analysis establishes an optional qualitative assessment to precede the quantitative assessment, if necessary. In the qualitative assessment, the entity must evaluate the totality of qualitative factors, including any recent fair value measurements, that impact whether an indefinite-lived intangible asset other than goodwill has a carrying amount that more likely than not exceeds its fair value. The entity must proceed to conducting a quantitative analysis, according to which the entity would record an impairment charge for the amount of the asset's fair value exceeding the carrying amount, if (1) the entity determines that such an impairment is more likely than not to exist, or (2) the entity foregoes the qualitative assessment entirely. The standards update will be effective for financial statements of periods beginning after September 15, 2012, with early adoption permitted. The adoption of ASU No. 2012-02 did not have a material impact on our statement of operations, financial position, or cash flows.

Item 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Interest Rate Risk

Our cash and cash equivalents are exposed to financial market risk due to fluctuations in interest rates, which may affect our interest income. As of December 31, 2013, our cash and cash equivalents included money market funds and short term deposits, including certain cash which is restricted, totaling approximately $19.7 million, and earned interest at a weighted average rate of approximately 0.1%. The value of the principal amounts is equal to the fair value of these instruments. Due to the relative short-term nature of our investment portfolio, our interest income is subject to changes in short-term interest rates. At current investment levels, our net income (loss) would vary by approximately $0.2 million on an annual basis for every 100 basis point change in our weighted average short-term interest rate. We do not use our portfolio for trading or other speculative purposes.

We utilize a combination of short-term and long-term debt to finance our operations and are exposed to interest rate risk on these debt obligations.

Our indebtedness under the senior secured credit facility bears interest at rates that fluctuate with changes in certain short-term prevailing interest rates. As of December 31, 2013, our outstanding borrowings under the term loan facility were $236.4 million (net of $2.3 million unamortized original issue discount). As of December 31, 2013, current borrowings under our credit agreement had an effective interest rate of 6.5% and weighted average interest rate of 6.00%, determined as the LIBOR rate (subject to a 1.25% floor) plus 4.75%.

As required by the terms of the Credit Agreement, we entered into a two-year, interest rate cap at 3.00% for 50% of the total amount of Term Loan principal outstanding on October 21, 2013. See Part II Item 8, Note 6 for more information on the refinancing of our debt. We will continue to assess the appropriateness of hedging interest rate risk with our outstanding variable debt under our current senior secured credit facilities.

Our net income would likely be affected by changes in market interest rates on our variable-rate obligations. As discussed above, our term loan facility is subject to a 1.25% LIBOR floor. Therefore, a 100 basis point increase in the December 31, 2013 market interest rate would increase interest expense under the revolving credit facilitiy and term loan by approximately $1.2 million on an annual basis.

Foreign Currency Exchange Risk

We have sales and expenses that are denominated in currencies other than the U.S. dollar and, as a result, have exposure to foreign currency exchange risk. In the event our exposure to foreign currency exchange risk increases to levels that we do not deem acceptable, we may choose to hedge those exposures. We did not enter into any derivative financial instruments to hedge such exposures in 2013 or 2012.

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Item 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Report of Independent Registered Public Accounting Firm

Board of Directors and Shareholders
Merge Healthcare Incorporated
Chicago, Illinois

We have audited the accompanying consolidated balance sheets of Merge Healthcare Incorporated ("the Company") as of December 31, 2013 and 2012 and the related consolidated statements of operations, comprehensive loss, shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2013. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our 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 audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes 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, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Merge Healthcare Incorporated at December 31, 2013 and 2012, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2013, in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Merge Healthcare Incorporated's internal control over financial reporting as of December 31, 2013, based on criteria established in Internal Control – Integrated Framework (1992) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and our report dated March 14, 2014, expressed an unqualified opinion thereon.

/s/BDO USA, LLP
Milwaukee, Wisconsin
March 14, 2014

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

ASSETS	December 31, 2013	December 31, 2012
Current assets:		
Cash and cash equivalents, including restricted cash of $392 at December 31, 2013 and $813 at December 31, 2012	$ 19,729	$ 35,875
Accounts receivable, net of reserves of $11,938 and $14,074 at December 31, 2013 and December 31, 2012	61,895	72,065
Inventory	5,851	5,979
Prepaid expenses	4,803	4,972
Deferred income taxes	1,915	3,135
Other current assets	12,631	21,621
Total current assets	106,824	143,647
Property and equipment:		
Computer equipment	8,930	7,754
Office equipment	2,857	2,699
Leasehold improvements	1,870	1,287
	13,657	11,740
Less accumulated depreciation	8,918	6,776
Net property and equipment	4,739	4,964
Purchased and developed software, net of accumulated amortization of $18,570 and $13,884 at December 31, 2013 and December 31, 2012	14,882	19,007
Other intangible assets, net of accumulated amortization of $34,466 and $25,007 at December 31, 2013 and December 31, 2012	26,200	35,628
Goodwill	214,374	214,312
Deferred income taxes	6,979	7,041
Other assets	8,413	12,254
Total assets	$ 382,411	$ 436,853
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 22,072	$ 24,438
Current maturities of long-term debt	2,490	-
Interest payable	-	4,944
Accrued wages	5,559	5,881
Restructuring accrual	1,301	222
Other current liabilities	8,205	12,606
Deferred revenue	55,183	52,355
Total current liabilities	94,810	100,446
Long-term debt, less current maturities, net of unamortized discount	233,942	250,046
Deferred income taxes	4,065	3,046
Deferred revenue	378	894
Income taxes payable	1,399	1,040
Other liabilities	2,557	3,920
Total liabilities	337,151	359,392
Shareholders' equity:		
Preferred Stock, $0.01 par value: 1,000,000 shares authorized; none issued	-	-

Series A Non-voting Preferred Stock, $0.01 par value: 50,000 shares authorized; none issued	-	-
Common stock, $0.01 par value: 150,000,000 shares authorized: 96,688,889 and 93,137,737shares issued and outstanding at December 31, 2013 and December 31, 2012	967	931
Common stock subscribed, 26,259 and 158,395 shares at December 31, 2013 and December 31, 2012		