MGC DIAGNOSTICS Corp
Form 10-Q
March 13, 2013
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

for the quarterly period ended January 31, 2013.

OR

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 for the transition period from ____________________ to _____________________.

Commission File Number 001-13543

MGC DIAGNOSTICS CORPORATION
(Exact name of registrant as specified in its charter)

Minnesota	**41-1579150**
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

350 Oak Grove Parkway, Saint Paul, Minnesota 55127-8599
(Address of principal executive offices)

Registrant s telephone number, including area code: **(651) 484-4874**

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

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

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

Large Accelerated Filer o Accelerated Filer o Non-Accelerated Filer o Smaller Reporting Company x

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

As of March 1, 2013, the Company had outstanding 3,901,607 shares of Common Stock, $0.10 par value.

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements.

MGC DIAGNOSTICS CORPORATION AND SUBSIDIARY
Consolidated Balance Sheets
January 31, 2013 and October 31, 2012
(In thousands, except share and per share data)

	January 31, 2013 (Unaudited)		October 31, 2012	
Assets				
Current Assets:				
Cash and cash equivalents	$	8,922	$	9,665
Accounts receivable, net of allowance for doubtful accounts of $105 and $98, respectively		6,029		5,860
Inventories, net of obsolescence reserve of $394 and $373, respectively		4,036		3,850
Prepaid expenses and other current assets		298		418
Total current assets		19,285		19,793
Property and equipment, net of accumulated depreciation of $3,925 and $3,876, respectively		753		578
Intangible assets, net		1,771		1,492
Other non-current assets		85		85
Total Assets	$	21,894	$	21,948
Liabilities and Shareholders Equity				
Current Liabilities:				
Accounts payable	$	2,006	$	2,094
Employee compensation		1,493		1,749
Deferred income		1,994		1,927
Warranty reserve		84		91
Other current liabilities and accrued expenses		509		442
Total current liabilities		6,086		6,303
Long-term liabilities:				
Long-term deferred income and other		1,300		895
Total Liabilities		7,386		7,198
Commitments and Contingencies				
Shareholders Equity:				
Common stock, $0.10 par value, authorized 25,000,000 shares, 4,000,678 and 3,986,350 shares issued and 3,901,607 and 3,885,279 shares outstanding in 2013 and 2012, respectively		390		388
Undesignated shares, authorized 5,000,000 shares, no shares issued and outstanding				
Additional paid-in capital		21,185		21,046
Accumulated deficit		(7,067)		(6,684)
Total Shareholders Equity		14,508		14,750
Total Liabilities and Shareholders Equity	$	21,894	$	21,948

See accompanying notes to consolidated financial statements.

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MGC DIAGNOSTICS CORPORATION AND SUBSIDIARY
Consolidated Statements of Comprehensive Loss
(Unaudited in thousands, except per share data)

	Three Months ended January 31, 2013	2012
Revenues		
Equipment, supplies and accessories revenues	$ 5,806	$ 5,372
Service revenues	1,202	1,056
	7,008	6,428
Cost of revenues		
Cost of equipment, supplies and accessories revenues	2,835	2,525
Cost of service revenues	351	334
	3,186	2,859
Gross margin	3,822	3,569
Operating expenses:		
Selling and marketing	2,126	1,775
General and administrative	1,418	1,145
Research and development	647	810
Amortization of intangibles	7	108
	4,198	3,838
Operating loss	(376)	(269)
Interest income		4
Loss from continuing operations before taxes	(376)	(265)
Provision for taxes	7	7
Loss from continuing operations	(383)	(272)
Discontinued operations		
Income from operations of discontinued operations		23
Net loss	(383)	(249)
Other comprehensive loss; net of tax		
Unrealized loss on securities		(1)
Comprehensive loss	$ (383)	$ (250)
Loss per share:		
Basic		
From continuing operations	$ (0.10)	$ (0.07)
From discontinued operations	0.00	0.00
Total	$ (0.10)	$ (0.07)
Diluted		
From continuing operations	$ (0.10)	$ (0.07)
From discontinued operations	0.00	0.00
Total	$ (0.10)	$ (0.07)
Weighted average common shares outstanding:		
Basic	3,891	3,780
Diluted	3,891	3,780

See accompanying notes to consolidated financial statements.

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MGC DIAGNOSTICS CORPORATION AND SUBSIDIARY
Consolidated Statements of Cash Flows
(Unaudited in thousands)

	Three Months Ended January 31, 2013	2012
Cash flows from operating activities:		
Net loss	$ (383)	$ (249)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation	55	64
Amortization	21	108
Stock-based compensation	101	137
Increase (decrease) in allowance for doubtful accounts	7	(3)
Decrease in inventory obsolescence reserve	21	47
Gain on disposal of equipment	(3)	
Changes in operating assets and liabilities:		
Accounts receivable	(176)	1,063
Inventories	(207)	(419)
Prepaid expenses and other current assets	120	37
Accounts payable	(88)	(189)
Employee compensation	(256)	(202)
Deferred income	314	(218)
Warranty reserve	(7)	(19)
Other current liabilities and accrued expenses	(3)	9
Net cash (used in) provided by operating activities	(484)	166
Cash flows from investing activities:		
Sales of investments		241
Purchases of property and equipment and intangible assets	(317)	(240)
Net cash (used in) provided by investing activities	(317)	1
Cash flows from financing activities:		
Proceeds from issuance of common stock under employee stock purchase plan	68	11
Proceeds from the exercise of stock options		40
Repurchase of common stock		(5)
Repurchase of common stock upon vesting of restricted stock awards	(10)	
Net cash provided by financing activities	58	46
Net increase in cash and cash equivalents	(743)	213
Cash and cash equivalents at beginning of year	9,665	8,461
Cash and cash equivalents at end of year	$ 8,922	$ 8,674
Cash paid for taxes	$ 16	$ 2
Supplemental non-cash items:		
Current and non-current liabilities issued for leasehold improvements	210	

See accompanying notes to consolidated financial statements.

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MGC DIAGNOSTICS CORPORATION AND SUBSIDIARY
Notes to Consolidated Financial Statements
(Unaudited)

(1) Basis of Presentation and Description of Business

MGC Diagnostics Corporation (the Company), through its Medical Graphics Corporation subsidiary, designs and markets non-invasive cardiorespiratory diagnostic systems that are sold under the MGC Diagnostics and MedGraphics brand and trade names. These cardiorespiratory diagnostic systems have a wide range of applications within cardiorespiratory healthcare.

The consolidated balance sheet as of January 31, 2013, the consolidated statements of comprehensive loss for the three months ended January 31, 2013 and 2012, and the consolidated statements of cash flows for the three months ended January 31, 2013 and 2012, and the related information presented in these notes have been prepared by management in accordance with U.S. generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X, without audit. Accordingly, they do not include all of the information and notes required by U.S. generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation of results have been included. The consolidated balance sheet at October 31, 2012 was derived from the audited consolidated financial statements as of that date. Operating results for the three months ended January 31, 2013 are not necessarily indicative of the results that may be expected for the year ending October 31, 2013. For further information, refer to the consolidated financial statements and notes thereto included in MGC Diagnostics Corporation s Annual Report on Form 10-K for the year ended October 31, 2012.

Preparation of the consolidated financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities made in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates. Estimates include accounts receivable, product warranty and inventory reserves, and depreciable lives of property, equipment and intangible assets (including internal software development costs).

The Company determined there were no events subsequent to January 31, 2013, that required recognition or disclosure in these consolidated financial statements.

(2) Summary of Significant Accounting Policies

Revenue Recognition

The Company recognizes revenue when persuasive evidence of an arrangement exists, transfer of title has occurred or services have been rendered, the selling price is fixed or determinable and collectability is reasonably assured. The Company s products are sold for cash or on unsecured credit terms requiring payment based on the shipment date. Credit terms can vary between customers due to many factors, but are generally, on average, 30 to 60 days. Revenue, net of discounts, is generally recognized upon shipment or delivery to customers in accordance with written sales terms. Standard sales terms do not include customer acceptance conditions, future credits, rebates, price protection or general rights of return. The terms of sales to both domestic customers and international distributors are identical, although adherence to these terms is more pervasive with domestic customers than with international customers. In instances when a customer order specifies final acceptance of the system, revenue recognition is deferred until all customer acceptance criteria have been met. Estimated warranty obligations are recorded upon shipment. Sales and use taxes are reported on a net basis, excluding them from revenues and cost of revenues.

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Service contract revenue is based on a stated contractual rate and is deferred and recognized ratably over the service period, which is typically from one to four years. Deferred income associated with service contracts was $2,919,000 and $2,615,000 as of January 31, 2013 and October 31, 2012, respectively. Revenue from installation and training services provided to customers is deferred until the service has been performed or no further obligations to perform the service exist. The amount of deferred installation and training revenue was $171,000 and $146,000 as of January 31, 2013 and October 31, 2012, respectively.

When a sale involves multiple deliverables, such as equipment, installation services and training, the amount of the sale consideration is allocated to each respective element based on the relative selling price and revenue is recognized when revenue recognition criteria for each element is met. Consideration allocated to delivered equipment is equal to the total arrangement consideration less the selling price of installation and training. The selling price of installation and training services is based on specific objective evidence, including third-party invoices.

No customer accounted for more than 10% of revenue in the three months ended January 31, 2013 and 2012.

Advance Payments from Customers

The Company typically does not receive advance payments from its customers in connection with the sale of its products. The Company occasionally enters into an arrangement under which a customer agrees to purchase a large quantity of product that is to be delivered over a period of time. Depending on the size of these arrangements, the Company may negotiate an advance payment from these customers. Advance payments from customers aggregated $6,000 and $23,000 as of January 31, 2013 and October 31, 2012, respectively. Revenue recognition for customer orders that include advance payments is consistent with the Company s revenue recognition policy described above.

Internal Software Development Costs

Internal software development costs consist primarily of internal salaries and consulting fees for developing software platforms for sale to or use by customers within equipment purchased from the Company. We capitalize costs related to the development of our software products, as all of these products will be used as an integral part of a product or process to be sold or leased. This software is primarily related to our BreezeSuite platform, including underlying support products.

We capitalize costs related to software developed for new products and significant enhancements of existing products once technological feasibility has been reached and all research and development for the components of the product have been completed. These costs are amortized on a straight-line basis over the estimated useful life of the related product, not to exceed seven years, commencing with the date the product becomes available for general release to our customers. At October 31, 2012, we had not yet amortized any capitalized software costs because the software had not been released for use. During the quarter ended January 31, 2013, the Company introduced Breeze WebReview software and began amortizing the related capitalized software costs using a five-year life. The achievement of technological feasibility and the estimate of a product s economic life require management s judgment. Any changes in key assumptions, market conditions or other circumstances could result in an impairment of the capitalized asset and a charge to our operating results.

Discontinued Operations

On August 28, 2012, the Company entered into several agreements with Life Time Fitness, Inc. and affiliated companies (Life Time Fitness) under which the Company sold and licensed to Life Time Fitness, the assets of the Company s New Leaf business, excluding contracts and other assets related to the Company s non-Life Time customers as part of the Company s renewed focus on its core business and its strategy of bringing innovative cardiorespiratory technology solutions to the market and continuing its best-in-class customer support and service.

Specifically, the Company sold to Life Time Fitness New Leaf-related software and support materials, New Leaf product inventory, and New Leaf trademarks, service marks, and websites. The Company also licensed to Life Time Fitness patents and other intellectual property for use in the general wellness and health and fitness field. The Company retained all rights to this intellectual property in the medical field. Finally, the Company and Life Time Fitness entered into a Transition Services and Supply Agreement that runs through June 30, 2014 under which the parties will provide services to transition the New Leaf business to Life Time Fitness.

The Company continues to provide its existing New Leaf customers other than Life Time Fitness with products and services under ongoing contractual obligations through June 30, 2014.

The Company expects to recognize revenue and expense associated with its on-going obligations to Life Time Fitness under the Transition Services and Supply Agreement, and expects to incur revenue and expenses from the products and services sold to non-Life Time Fitness customers through June 30, 2014. The Company believes the expected cash flows from these activities are not sufficient to preclude the Company from using discontinued operations treatment for the event.

As a result of its August 28, 2012 sale of the New Leaf assets, the Company has eliminated all fiscal 2012 revenues and expenses associated with its New Leaf business from its statements of comprehensive loss and has reported the net income (loss) from its New Leaf activities as discontinued operations. Revenues included in discontinued operations totaled $631,000 for the quarter ended January 31, 2012. Current assets and other non-current assets include $150,000 and 85,000, respectively, as of both January 31, 2013 and October 31, 2012 for the deferred purchase price.

(3) Stock-Based Compensation and Stock Options

The MGC Diagnostics Corporation 2007 Stock Incentive Plan (the 2007 Plan) and the MGC Diagnostics Corporation 2002 Stock Option Plan (the 2002 Plan) both provide that incentive stock options and nonqualified stock options to purchase shares of common stock may be granted at prices determined by the Compensation Committee, except that the purchase price of incentive stock options may not be less than the fair market value of the stock at date of grant. Under the 2007 Plan, options generally expire no later than seven years from the grant date while under the 2002 Plan all options expire no later than ten years from the grant date. Options under both plans are subject to various vesting schedules. In addition, the 2007 Plan allows the granting of restricted stock awards, stock appreciation rights and performance stock.

Total stock-based compensation expense included in the Company s statements of comprehensive loss for the three months ended January 31, 2013 and 2012 was $101,000 and $137,000, respectively.

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Stock Options

A summary of the Company s stock option activity for the three-month periods ended January 31, 2013 and 2012 is presented in the following table:

	For the three months ended			
	January 31, 2013		January 31, 2012	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding at beginning of period	286,072	$ 6.57	346,572	$ 6.31
Granted	5,900	6.76		
Exercised			(17,500)	2.30
Expired or cancelled	(13,502)	6.81		
Outstanding at end of period	278,470	$ 6.56	329,072	$ 6.53

The following table summarizes information concerning stock options outstanding as of January 31, 2013:

Exercise Prices	Number Outstanding and Subject to Exercise	Weighted Average Remaining Contractual Life
$ 2.00	1,150	