

BSD MEDICAL CORP
Form 10-Q
April 09, 2014

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

FORM 10-Q

(Mark One)

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended February 28, 2014

Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from _____ to _____

Commission File No. 001-32526

BSD Medical Corporation
(Exact Name of Registrant as Specified in Its Charter)

Delaware
(State or other jurisdiction of incorporation
or organization)

75-1590407
(I.R.S. Employer Identification No.)

2188 West 2200 South
Salt Lake City, Utah 84119
(Address of principal executive offices, including zip code)

(801) 972-5555
(Registrant's telephone number, including area code)

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

Indicate by check mark whether the Registrant 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 No

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting

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company” in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

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

As of April 8, 2014, there were 33,981,871 shares of the Registrant’s common stock, \$0.001 par value per share, outstanding.

BSD MEDICAL CORPORATION
FORM 10-Q

FOR THE QUARTER ENDED FEBRUARY 28, 2014

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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

BSD MEDICAL CORPORATION
Condensed Balance Sheets
(Unaudited)

ASSETS	February 28, 2014	August 31, 2013
Current assets:		
Cash and cash equivalents	\$7,023,187	\$9,450,528
Accounts receivable, net of allowance for doubtful accounts of \$20,000	669,988	899,969
Related party trade accounts receivable	5,026	24,201
Inventories, net	2,430,385	2,445,770
Other current assets	153,565	200,028
Total current assets	10,282,151	13,020,496
Property and equipment, net	1,286,087	1,319,880
	\$11,568,238	\$14,340,376
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$334,085	\$521,417
Accrued liabilities	623,179	573,880
Customer deposits	324,630	317,480
Deferred revenue – current portion	693,808	730,593
Total current liabilities	1,975,702	2,143,370
Deferred revenue – net of current portion	13,038	53,115
Total liabilities	1,988,740	2,196,485
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, \$.001 par value; 10,000,000 shares authorized, no shares issued and outstanding	-	-
Common stock, \$.001 par value, 80,000,000 shares authorized, 34,006,202 shares issued	34,007	34,007
Additional paid-in capital	58,157,627	57,739,056
Treasury stock, 24,331 shares at cost	(234)	(234)
Accumulated deficit	(48,611,902)	(45,628,938)
Total stockholders' equity	9,579,498	12,143,891

\$11,568,238 \$14,340,376

See accompanying notes to condensed financial statements

BSD MEDICAL CORPORATION
Condensed Statements of Comprehensive Loss
(Unaudited)

	Three Months Ended		Six Months Ended	
	February 28, 2014	February 28, 2013	February 28, 2014	February 28, 2013
Revenues:				
Sales	\$1,616,076	\$766,084	\$2,847,635	\$1,283,698
Sales to related parties	1,748	6,275	18,434	76,546
Equipment rental	72,900	46,900	155,300	118,800
Total revenues	1,690,724	819,259	3,021,369	1,479,044
Cost of Revenues:				
Cost of sales	918,426	411,365	1,547,137	820,235
Cost of related party sales	259	5,069	7,913	66,446
Cost of equipment rental	2,947	2,947	5,894	5,894
Total cost of revenues	921,632	419,381	1,560,944	892,575
Gross margin	769,092	399,878	1,460,425	586,469
Operating costs and expenses:				
Research and development	559,287	558,691	1,062,044	1,085,958
Selling, general and administrative	1,682,319	1,705,682	3,387,032	3,594,931
Total operating costs and expenses	2,241,606	2,264,373	4,449,076	4,680,889
Loss from operations	(1,472,514)	(1,864,495)	(2,988,651)	(4,094,420)
Other income (expense):				
Interest income	5,104	6,720	11,427	16,666
Other expense	(2,693)	(3,622)	(5,740)	(2,307)
Total other income	2,411	3,098	5,687	14,359
Loss before income taxes	(1,470,103)	(1,861,397)	(2,982,964)	(4,080,061)
Income tax benefit	-	-	-	-
Net comprehensive loss	\$(1,470,103)	\$(1,861,397)	\$(2,982,964)	\$(4,080,061)
Net loss per common share:				
Basic	\$(0.04)	\$(0.06)	\$(0.09)	\$(0.14)
Diluted	\$(0.04)	\$(0.06)	\$(0.09)	\$(0.14)
Weighted average number of shares outstanding:				
Basic	33,982,000	29,778,000	33,982,000	29,778,000

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Diluted	33,982,000	29,778,000	33,982,000	29,778,000
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See accompanying notes to condensed financial statements

BSD MEDICAL CORPORATION
Condensed Statements of Cash Flows
(Unaudited)

	Six Months Ended	
	February 28, 2014	February 28, 2013
Cash flows from operating activities:		
Net loss	\$(2,982,964)	\$(4,080,061)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	61,377	70,026
Stock-based compensation	418,571	576,332
Decrease (increase) in:		
Receivables	249,156	(183,526)
Inventories	15,385	23,922
Other current assets	46,463	(53,308)
Increase (decrease) in:		
Accounts payable	(187,332)	103,455
Accrued liabilities	49,299	212,304
Customer deposits	7,150	16,270
Deferred revenue	(76,862)	(43,337)
Net cash used in operating activities	(2,399,757)	(3,357,923)
Cash flows from investing activities:		
Purchase of property and equipment	(27,584)	(12,739)
Cash flows from financing activities		
	-	-
Net decrease in cash and cash equivalents	(2,427,341)	(3,370,662)
Cash and cash equivalents, beginning of the period	9,450,528	11,102,508
Cash and cash equivalents, end of the period	\$7,023,187	\$7,731,846

See accompanying notes to condensed financial statements

BSD MEDICAL CORPORATION

Notes to Condensed Financial Statements
(Unaudited)

Note 1. Basis of Presentation

The interim financial information of BSD Medical Corporation (the "Company") as of February 28, 2014 and for the three months and six months ended February 28, 2014 and February 28, 2013, is unaudited, and the condensed balance sheet as of August 31, 2013, is derived from our audited financial statements. The accompanying unaudited condensed balance sheets as of February 28, 2014 and August 31, 2013, the related unaudited condensed statements of comprehensive loss for the three months and six months ended February 28, 2014 and February 28, 2013, and the related unaudited condensed statements of cash flows for the six months ended February 28, 2014 and February 28, 2013, have been prepared in accordance with U.S. generally accepted accounting principles for interim financial reporting and pursuant to the rules and regulations of the Securities and Exchange Commission (the "SEC"). The condensed financial statements do not include all of the information and notes required by U.S. generally accepted accounting principles for complete financial statements. These condensed financial statements should be read in conjunction with the notes thereto, and the financial statements and notes thereto included in our annual report on Form 10-K for the year ended August 31, 2013.

All adjustments (consisting only of normal recurring adjustments) necessary for the fair presentation of our financial position as of February 28, 2014 and August 31, 2013, our results of operations for the three months and six months ended February 28, 2014 and February 28, 2013, and our cash flows for the six months ended February 28, 2014 and February 28, 2013, have been included. The results of operations for the three months and six months ended February 28, 2014, may not be indicative of the results for our fiscal year ending August 31, 2014.

Certain amounts in the prior periods have been reclassified to conform to the current period presentation.

Note 2. Inventories

Inventories consisted of the following:

	February 28, 2014	August 31, 2013
Parts and supplies	\$ 1,330,259	\$ 1,353,614
Work-in-process	898,962	990,668
Finished goods	351,164	201,488
Reserve for obsolete inventory	(150,000)	(100,000)
Inventories, net	\$ 2,430,385	\$ 2,445,770

Note 3. Property and Equipment

Property and equipment consisted of the following:

	February 28, 2014	August 31, 2013
Equipment	\$ 1,426,128	\$ 1,401,811
Rental equipment	58,940	58,940
Furniture and fixtures	303,226	300,061
Building improvements	54,736	54,736
Building	956,000	956,000
Land	244,000	244,000
	3,043,030	3,015,548
Less accumulated depreciation	(1,756,943)	(1,695,668)
Property and equipment, net	\$ 1,286,087	\$ 1,319,880

Note 4. Stockholders' Equity

The Company has 10,000,000 authorized shares of \$.001 par value preferred stock. As of February 28, 2014 and August 31, 2013, there were no shares of preferred stock outstanding. The Company also has 80,000,000 authorized shares of \$.001 par value common stock.

Shelf Registration Statement

On September 28, 2012, we filed a universal shelf registration statement with the SEC for the issuance of common stock, preferred stock, warrants, senior debt, subordinated debt and units up to an aggregate amount of \$50.0 million. We may periodically offer one or more of these securities in amounts, prices and terms to be announced when and if the securities are offered. On October 11, 2012, the universal shelf registration statement was declared effective by the SEC.

Warrants

A summary of the outstanding warrants issued in prior stock offerings as of February 28, 2014, and changes during the six months then ended, is as follows:

	Shares	Weighted- Average Exercise Price	Weighted- Average Remaining Contract Term (Years)
Outstanding as of August 31, 2013	5,457,305	\$ 2.93	
Issued	-	-	
Exercised	-	-	
Forfeited or expired	-	-	

Outstanding and exercisable as of February
28, 2014

5,457,305 \$ 2.93 3.46

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Note 5. Net Loss Per Common Share

The computation of basic earnings per common share is based on the weighted average number of shares outstanding during the period. The computation of diluted earnings per common share is based on the weighted average number of shares outstanding during the period plus the weighted average common stock equivalents which would arise from the exercise of stock options and warrants outstanding using the treasury stock method and the average market price per share during the period. Common stock equivalents are not included in the diluted loss per share calculation when their effect is anti-dilutive.

No stock options or warrants are included in the computation of diluted weighted average number of shares for the three months and six months ended February 28, 2014 and February 28, 2013 because the effect would be anti-dilutive. As of February 28, 2014, we had outstanding options and warrants to purchase a total of 9,519,544 shares of our common stock that could have a future dilutive effect on the calculation of earnings per share.

Note 6. Related Party Transactions

During the three months ended February 28, 2014 and February 28, 2013, we had sales of \$1,748 and \$6,275, respectively, to entities controlled by a significant stockholder and member of the Board of Directors. These related party transactions represent approximately 0.1% and 0.8% of total sales for each respective three-month period. During the six months ended February 28, 2014 and February 28, 2013, we had sales of \$18,434 and \$76,546 to these related parties, representing approximately 0.6% and 5.2% of total sales for each respective six-month period.

As of February 28, 2014 and August 31, 2013, our accounts receivable included \$5,026 and \$24,201, respectively, from these related parties. Also, included in customer deposits as of February 28, 2014 and August 31, 2013, was \$159,980 towards the purchase of a hypothermia system from this same related party.

Note 7. Stock-Based Compensation

We have both an employee and director stock incentive plan, which are described more fully in Note 10 to the financial statements in our 2013 Annual Report on Form 10-K, as amended. As of February 28, 2014, we had approximately 1,800,000 shares of common stock reserved for future issuance under the stock incentive plans.

Stock-based compensation cost is measured at the grant date based on the value of the award granted using the Black-Scholes option pricing model, and recognized over the period in which the award vests. For stock awards no longer expected to vest, any previously recognized stock compensation expense is reversed in the period of termination. The stock-based compensation expense has been allocated to the various categories of operating costs and expenses in a manner similar to the allocation of payroll expense as follows:

	Three Months Ended		Six Months Ended	
	February	February	February	February
	28,	28,	28,	28,
	2014	2013	2014	2013
Cost of sales	\$ 15,337	\$ 16,022	\$ 30,987	\$ 32,045
Research and development	45,641	50,285	92,089	100,570
Selling, general and administrative	141,364	220,113	295,495	443,717
Total	\$ 202,342	\$ 286,420	\$ 418,571	\$ 576,332

During the six months ended February 28, 2014, we granted employees a total of 120,000 stock options at exercise prices ranging from \$1.17 to \$1.34 generally with one third vesting each year for the next three years. The estimated weighted average grant date fair value per share of these stock options was \$0.62, and our weighted average assumptions used in the Black-Scholes valuation model to determine this estimated fair value are as follows:

Expected volatility	64.34	%
Expected dividends	0	%
Expected term	7.35	years
Risk-free interest rate	2.20	%

Unrecognized stock-based compensation expense expected to be recognized over the estimated weighted-average amortization period of .89 years is approximately \$1,188,000 as of February 28, 2014.

A summary of the time-based stock option awards as of February 28, 2014, and changes during the six months then ended, is as follows:

	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contract Term (Years)	Aggregate Intrinsic Value
Outstanding as of August 31, 2013	4,212,573	\$ 2.85		
Granted	120,000	1.20		
Exercised	-	-		
Forfeited or expired	(270,334)	2.89		
Outstanding as of February 28, 2014	4,062,239	\$ 2.80	6.30	\$ 0
Exercisable as of February 28, 2014	2,205,263	\$ 3.79	4.69	\$ 0

The aggregate intrinsic value in the preceding table represents the total pre-tax intrinsic value, based on our closing stock price of \$1.14 as of February 28, 2014. There were no outstanding, in-the-money options as of that date.

Note 8. Supplemental Cash Flow Information

We paid no amounts for interest expense and income taxes during the six months ended February 28, 2014 and February 28, 2013.

During the six months ended February 28, 2014 and February 28, 2013 we had no non-cash financing and investing activities.

Note 9. Recent Accounting Pronouncements

No new accounting pronouncements were adopted during the six months ended February 28, 2014 that had a material impact on our financial statements. No new accounting pronouncements were issued during the six months ended February 28, 2014 and through the date of filing this report that we believe are applicable to, or would have a material impact on our financial statements.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

This Management's Discussion and Analysis of Financial Condition and Results of Operations and other parts of this quarterly report on Form 10-Q contain forward-looking statements that involve risks and uncertainties. Forward-looking statements can also be identified by words such as "anticipates," "expects," "believes," "plans," "predicts," and similar terms. Forward-looking statements are not guarantees of future performance and our actual results may differ significantly from the results discussed in the forward-looking statements. Factors that might cause such differences include, but are not limited to, those discussed in the subsection entitled "Forward-Looking Statements" below. The following discussion should be read in conjunction with our financial statements and notes thereto included in this report. We assume no obligation to revise or update any forward-looking statements for any reason, except as required by law.

Overview

BSD Medical Corporation (the "Company" or "BSD") was originally incorporated under the laws of the State of Utah on March 17, 1978. On July 3, 1986, the Company was reincorporated in the State of Delaware.

We develop, manufacture, market and service systems to treat cancer and benign diseases using heat therapy delivered using focused microwave energy and radiofrequency ("RF") and microwave energy. Our business objectives are to commercialize our products for the treatment of cancer and to further expand our products to treat other diseases and medical conditions. Our product line for cancer therapy has been created to offer hospitals and clinics a complete solution for thermal treatment of cancer using microwave/RF systems, including both ablation and hyperthermia treatment systems. Studies have shown that both ablation and hyperthermia treatments kill cancer, but they have different clinical applications.

Our microwave ablation system is used to ablate (destroy) soft tissue with heat alone. Thermal ablation usually refers to heat treatments delivered at temperatures above 55°C for short periods of time. Thermal ablation is used to destroy local tumors using a short intense focus of heat on a specific area.

Our hyperthermia cancer treatment systems are used to treat cancer with heat (hyperthermia) while boosting the effectiveness of radiation and chemotherapy for certain tumors through a number of biological mechanisms. Hyperthermia is usually used to increase the effectiveness of other therapies; e.g., radiation therapy and chemotherapy for the treatment of locally advanced cancers. Hyperthermia usually refers to treatments delivered at temperatures of 40-45°C for one hour.

Commercialization of our systems that are used to treat cancer is our most immediate business objective. Current and future cancer treatment sites for our systems may include cancers of the prostate, breast, head, neck, bladder, cervix, colon/rectum, ovaries, esophagus, liver, kidney, brain, bone, stomach and lung. Our cancer treatment systems have been used to treat thousands of patients throughout the world and have received many awards, including the Frost & Sullivan "Technology Innovation of the Year Award" for cancer therapy devices, which was awarded in 2005 for the development of the BSD-2000 Hyperthermia System.

Although we have not yet taken advantage of many of these market opportunities, we believe our technology has application for a number of other medical purposes in addition to cancer.

We are experiencing growth in our operating revenues from our MicroThermX® Microwave Ablation System ("MicroThermX") line of products as a result of an exclusive, long-term, multi-million dollar distribution agreement with Terumo Europe NV (Terumo), a wholly owned subsidiary of Terumo Corporation. The agreement with Terumo, which we announced in April 2013, covers 100 countries in Europe, Western Asia, and Northern Africa. In addition,

MicroThermX revenues and sales of disposable SynchroWave antennas have increased in the U.S. market as well.

The number of hyperthermia systems sold varies from period to period and sales are impacted by several factors including regulatory, economic and other healthcare industry factors. We have experienced declining hyperthermia revenues from our distributor in Europe, a related party. We have entered into distribution agreements for our hyperthermia systems in China, South Korea and Taiwan. We anticipate these distribution agreements will result in increased hyperthermia sales. For example, we recently received approval to market our BSD-2000 in Taiwan and commenced shipping systems to Taiwan in February, 2014. Regulatory approvals are pending in China and South Korea, but we are not able to predict the outcome of these efforts.

We recognize revenues from the sale of our ablation and hyperthermia cancer treatment systems and related parts and accessories (collectively, product sales), the sale of disposable devices used with certain of our systems, from training, and from service support contracts and other miscellaneous revenues. We also recognize revenues from equipment rental, including fee-per-use rental income from our MicroThermX.

Our current corporate strategy includes the possibility of entering into additional collaborative arrangements with third parties to expand and improve the commercialization of all our products, including our hyperthermia systems. The recent signing of the master distribution agreement with Terumo for our MicroThermX line of products was a result of this strategy. Consistent with this strategy, we continue to seek out and identify opportunities and, if possible, secure a transaction or transaction(s) relating to BSD's hyperthermia business, including, but not limited to, partnering or other collaborative agreements, a sale of assets and/or other strategic arrangements. There can be no assurance that the exploration of strategic alternatives will result in any agreements or transactions, or that, if completed, any agreements or transactions will be successful or on attractive terms.

Backlog

As of the date of the filing of this report, we had a total sales backlog of approximately \$1,590,000.

Results of Operations

Fluctuation in Operating Results

Our results of operations have fluctuated in the past and may fluctuate in the future from year to year as well as from quarter to quarter. Revenue may fluctuate as a result of factors relating to the demand and market acceptance for our ablation and hyperthermia systems and related component parts and services, world-wide economic conditions, availability of financing for our customers, changes in the medical capital equipment market, changes in order mix and product order configurations, competition, regulatory developments, insurance reimbursement and other matters. Operating expenses may fluctuate as a result of the timing of sales and marketing activities, research and development, and general and administrative expenses associated with our potential growth. For these and other reasons described elsewhere, our results of operations for a particular period may not be indicative of operating results for any other period.

Revenues

We recognized revenue from the sale of our ablation and hyperthermia cancer treatment systems and related parts and accessories (collectively, product sales), the sale of disposable devices used with certain of our systems, from training, and from service support contracts and other miscellaneous revenues. We also recognized revenues from equipment rental, including our fee-per-use rental income from our MicroThermX.

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For the three months and six months ended February 28, 2014 and February 28, 2013, our revenues consisted of the following:

	Three Months Ended February 28,		Six Months Ended February 28,	
	2014	2013	2014	2013
Product sales	\$ 1,017,875	\$ 491,700	\$ 1,822,275	\$ 710,700
Disposable devices	478,980	204,360	840,740	430,135
Service contracts and other	120,969	76,299	203,054	219,409
	1,617,824	772,359	2,866,069	1,360,244
Equipment rental	72,900	46,900	155,300	118,800
Total	\$ 1,690,724	\$ 819,259	\$ 3,021,369	\$ 1,479,044

Total revenues for the three months ended February 28, 2014 were \$1,690,724 compared to total revenues of \$819,259 for the three months ended February 28, 2013, an increase of \$871,465, or approximately 106%. Total revenues for the six months ended February 28, 2014 were \$3,021,369 compared to total revenues of \$1,479,044 for the six months ended February 28, 2013, an increase of \$1,542,325, or approximately 104%.

The increase in total revenues in the current year three and six month periods is due primarily to increases in all sources of revenues from our MicroThermX line of products, including increased sales of MicroThermX systems and consumable devices from increasing sales of SynchroWave disposable antennas that are used in each ablation treatment. Sales from hyperthermia related products also increased over prior year periods, but at a lower growth rate than for MicroThermX products.

During the third quarter of fiscal year 2013, we commenced shipping MicroThermX systems and SynchroWave antennas to Terumo Europe pursuant to an exclusive distribution agreement covering 100 countries in Europe, Western Asia, and Northern Africa. In addition, with the successful introduction of our fee-per-use rental program and accelerating sales of disposable SynchroWave antennas, our revenues from our MicroThermX family of products continue to grow.

During the three months and six month periods ended February 28, 2014, we sold 2 and 4 hyperthermia systems, respectively. By comparison, we sold 2 hyperthermia systems in the three months ended February 28, 2013.

Historically, our revenues have fluctuated significantly from period to period because our sales were based upon a relatively small number of hyperthermia systems, the sales price of each being substantial enough to greatly impact revenue levels in the periods in which they occur. However, we have been unable to sustain an increase in the number of hyperthermia systems sold due to various factors, including: non-acceptance by cancer-treating physicians of hyperthermia therapy; inadequate reimbursement rates from third-party payers; and significant uncertainty in the U.S. healthcare industry due to recent governmental healthcare reform. We believe these difficulties may continue to negatively impact the sales of our hyperthermia systems and our operating results.

At times, we have derived a significant portion of our revenues from sales to related parties. All of our related party revenue results from the sale of hyperthermia systems and related component parts and services to Dr. Sennewald Medizintechnik GmbH. Dr. Sennewald, one of our directors and significant stockholders, is a stockholder, executive officer and a director of Medizintechnik. We derived \$1,748, or approximately 0.1%, of our total revenue in the three

months ended February 28, 2014, from sales to related parties, compared to \$6,275 or approximately 0.8%, in the three months ended February 28, 2013. We derived \$18,434, or approximately 0.6%, of our total revenue in the six months ended February 28, 2014, from sales to related parties, compared to \$76,546, or approximately 5%, in the six months ended February 28, 2013. We had no sales of hyperthermia systems to related parties in the three months or six months ended February 28, 2014, nor in the three and six month periods ended February 28, 2013. All of our revenue growth in fiscal 2014 has come from non-related parties.

The following tables summarize the sources of our revenues for the three months and six months ended February 28, 2014 and 2013:

Non-Related Parties	Three Months Ended February 28,		Six Months Ended February 28,	
	2014	2013	2014	2013
Product sales	\$ 1,017,875	\$ 491,700	\$ 1,822,275	\$ 660,700
Disposable devices	478,980	203,310	830,690	427,735
Service contracts and other	192,121	117,974	349,970	314,063
Total	\$ 1,688,976	\$ 812,984	\$ 3,002,935	\$ 1,402,498

Related Parties	Three Months Ended February 28,		Six Months Ended February 28,	
	2014	2013	2014	2013
Product sales	\$ 0	\$ 0	\$ 0	\$ 50,000
Disposable devices	0	1,050	10,050	2,400
Service contracts and other	1,748	5,225	8,384	24,146
Total	\$ 1,748	\$ 6,275	\$ 18,434	\$ 76,546

Cost of Revenues

Cost of sales includes raw material, labor and allocated overhead costs. We calculate and report separately cost of sales for both non-related and related party sales, which are sales to Medizintechnik. Cost of sales as a percentage of sales will fluctuate from period to period depending on the mix of sales for the period and the type and configuration of the hyperthermia systems sold during the period. Cost of equipment rental includes installation, training, maintenance and support costs and depreciation of rental equipment.

Total cost of revenues for the three months ended February 28, 2014 was \$921,632, compared to \$419,381 for the three months ended February 28, 2013, an increase of \$502,251, or approximately 120%. Total cost of revenues for the six months ended February 28, 2014 was \$1,560,944, compared to \$892,575 for the six months ended February 28, 2013, an increase of \$668,369, or approximately 75%. These increases resulted from the significantly increased sales in the current year.

Gross Margin

Our gross margin and gross margin percentage will fluctuate from period to period depending on the mix of revenues reported for the period and the type and configuration of the hyperthermia systems sold during the period. Our total gross margin was \$769,092, or approximately 45% of total revenues, for the three months ended February 28, 2014, compared to a gross margin of \$399,878, or approximately 49%, for the three months ended February 28, 2013. The increase in the gross margin in the first three months of the current fiscal year compared to the first three months of the prior fiscal year is the result of the significantly higher level of sales. The lower gross margin percentage in the three months ended February 28, 2014, compared to the three months ended February 28, 2013, reflects the change in the product sales mix; in the recent three month period, hyperthermia systems, which have higher gross margins than MicroThermX systems, were a lower percent of total sales. This decrease in gross margin percentage as a result of hyperthermia systems being a lower percent of total sales was partially offset by the increasing sales of SynchroWave disposable antennas and fee-per-use rental revenues from our MicroThermX, which have a higher gross margin than MicroThermX systems. Our total gross margin was \$1,460,425, or approximately 48% of total revenues, for the six months ended February 28, 2014, and \$586,469, or approximately 40%, for the six months ended February 28, 2013. The increase in gross margin and gross margin percentage in the first six months of the current fiscal year compared to the first six months of the prior fiscal year resulted from the significantly higher level of sales, and a more favorable mix of products sold, including increasing sales of SynchroWave disposable antennas and fee-per-use rental revenues from our MicroThermX. In addition, as our sales volume increases, we are more able to fully absorb certain fixed overhead costs that are allocated to cost of sales, thus increasing our gross profit percentage.

Operating Costs and Expenses

Research and Development Expenses – Research and development expenses include expenditures for new product development and development of enhancements to existing products. Research and development expenses for the three months ended February 28, 2014 were \$559,287, compared to \$558,691 for the three months ended February 28, 2013, an increase of \$596 or approximately 0.1%. Research and development expenses for the six months ended February 28, 2014 were \$1,062,044, compared to \$1,085,958 for the six months ended February 28, 2013, a decrease of \$23,914 or approximately 2.2%.

Selling, General and Administrative Expenses – Selling, general and administrative expenses were \$1,682,319 for the three months ended February 28, 2014, compared to \$1,705,682 for the three months ended February 28, 2013, a decrease of \$23,363, or approximately 1.4%. Selling, general and administrative expenses were \$3,387,032 for the six months ended February 28, 2014, compared to \$3,594,931 for the six months ended February 28, 2013, a decrease of \$207,899, or approximately 5.8%. These decreases are primarily due to lower spending on legal costs and lower stock based compensation expenses. As part of our continuing roll out of the MicroThermX® product line and the support of its global distribution network, we have increased our marketing and sales staff and incurred additional marketing, sales and related operating expenses. We believe that the level of our selling, general and administrative expenses may increase over the levels reported for the first half of our current fiscal year, and the increase may be significant.

Other Income (Expense)

During the three and six months ended February 28, 2014 and 2013, other income (expense) was not material to our operations.

Liquidity and Capital Resources

From inception through February 28, 2014, we have generated an accumulated deficit of \$48,611,902 where our operating revenues have been insufficient to cover our operating expenses. We have financed our operations primarily through the sale of our common stock. As of February 28, 2014, we had cash and cash equivalents of \$7,023,187, comprised primarily of money market funds and savings accounts. Current assets were \$10,282,151, including \$675,014 of net accounts receivable.

As of February 28, 2014, we had current liabilities totaling \$1,975,702, comprised of accounts payable, accrued liabilities, customer deposits and deferred revenue incurred in the normal course of our business. Our long-term liabilities consisted of deferred revenue of \$13,038.

Shelf Registration Statement and April 2013 Stock Offering

On September 28, 2012, we filed a universal shelf registration statement (Form S-3; file number 333-184164) with the SEC for the issuance of common stock, preferred stock, warrants, senior debt, subordinated debt and units up to an aggregate amount of \$50.0 million. On October 11, 2012, the universal shelf registration statement was declared effective by the SEC. We may periodically offer one or more of these securities in amounts, prices and terms to be announced when and if the securities are offered. At the time any of the securities covered by the registration statement are offered for sale, a prospectus supplement will be prepared and filed with the SEC containing specific information about the terms of any such offering.

In April 2013, we completed an offering of 4,065,042 shares of our common stock and warrants to purchase a total of 3,048,782 shares of our common stock with certain institutional investors (the "Offering"). The Offering was completed using our shelf registration statement, and net proceeds to us were approximately \$4.6 million.

The warrants became exercisable six months and one day following the closing date of the Offering and will remain exercisable for five years thereafter at an exercise price of \$1.65 per share. The exercise price of the warrants is subject to adjustment in the case of stock splits, stock dividends, combinations of shares and similar recapitalization transactions. The exercisability of the warrants may be limited if, upon exercise, the holder or any of its affiliates would beneficially own more than 4.9% of our common stock.

We agreed with each of the purchasers that, subject to certain exceptions, we will not, within the 30 trading days following the closing of the Offering (which period may be extended in certain circumstances), enter into any agreement to issue or announce the issuance or proposed issuance of any securities.

We also agreed with each of the purchasers that while the warrants are outstanding, we will not affect or enter into an agreement to affect a "Variable Rate Transaction," which means a transaction in which we:

- Issue or sell any convertible securities either (A) at a conversion, exercise or exchange rate or other price that is based upon and/or varies with the trading prices of, or quotations for, the shares of our common stock at any time after the initial issuance of such convertible securities, or (B) with a conversion, exercise or exchange price that is subject to being reset at some future date after the initial issuance of such convertible securities or upon the occurrence of specified or contingent events directly or indirectly related to our business or the market for our common stock, other than pursuant to a customary "weighted average" anti-dilution provision; or
- Enter into any agreement (including, without limitation, an equity line of credit) whereby we may sell securities at a future determined price (other than standard and customary "preemptive" or "participation")

rights).

We also agreed with each of the purchasers if we issue securities within the 12 months following the closing of the Offering, the purchasers shall have the right to purchase all of the securities on the same terms, conditions and price provided for in the proposed issuance of securities.

We also agreed to indemnify each of the purchasers against certain losses resulting from our breach of any of our representations, warranties, or covenants under agreements with each of the purchasers, as well as under certain other circumstances described in the Purchase Agreement.

Cash Flows from Operating, Investing and Financing Activities

During the six months ended February 28, 2014, we used net cash of \$2,399,757 in operating activities, primarily as a result of our net loss of \$2,982,964, decreased by non-cash expenses totaling \$479,948, including depreciation and amortization and stock-based compensation. Net cash used in operating activities also included decreases in receivables of \$249,156, inventories of \$15,385, and other current assets of \$46,463. Cash used in operating activities also included reductions in accounts payable of \$187,332 and deferred revenue of \$76,862, partially offset by increases in accrued liabilities of \$49,299 and customer deposits of \$7,150.

During the six months ended February 28, 2013, we used net cash of \$3,357,923 in operating activities, primarily as a result of our net loss of \$4,080,061, decreased by non-cash expenses totaling \$646,358, comprised of depreciation and amortization and stock-based compensation. Net cash used in operating activities also included increases in receivables of \$183,526 and other current assets of \$53,308 and a decrease in deferred revenue of \$43,337, partially offset by a decrease in inventories of \$23,922 and increases in accounts payable of \$103,455, accrued liabilities of \$212,304 and customer deposits of \$16,270.

Net cash used in investing activities, resulting from the purchase of property and equipment, was \$27,584 and \$12,739 for the six months ended February 28, 2014 and 2013, respectively.

We had no net cash provided by or used in financing activities for the six months ended February 28, 2014 and 2013, respectively.

Although we believe that our current cash and cash equivalents are sufficient to fund our operations for the next twelve months, we expect that we will need to raise additional capital. We have considered and will continue to consider and evaluate financing options.

We cannot be certain or provide any assurance that any financing will be available when needed or will be available on terms acceptable to us. If we raise equity capital, our stockholders will be diluted. Insufficient funds may require us to delay, scale back or eliminate some or all of our programs designed to facilitate the commercialization of our systems or entry into new markets.

As of February 28, 2014, we had no significant commitments for the purchase of property and equipment.

We had no material off balance sheet arrangements as of February 28, 2014.

Critical Accounting Policies

The following is a discussion of our critical accounting policies and estimates that management believes are material to an understanding of our results of operations and which involve the exercise of judgment or estimates by management.

Revenue Recognition: Revenue from the sale of cancer treatment systems is recognized when a purchase order has been received, the system has been shipped, the selling price is fixed or determinable, and collection is reasonably assured. Most system sales are F.O.B. shipping point; therefore, shipment is deemed to have occurred when the product is delivered to the transportation carrier. Most system sales do not include installation. If installation is included as part of the contract, revenue is not recognized until installation has occurred, or until any remaining installation obligation is deemed to be perfunctory. Some sales of systems may include training as part of the sale. In such cases, the portion of the revenue related to the training, calculated based on the amount charged for training on a stand-alone basis, is deferred and recognized when the training has been provided. The sales of our cancer treatment systems do not require specific customer acceptance provisions and do not include the right of return except in cases where the product does not function as warranted by us, or are not within product specifications. To date, returns have not been significant.

Revenue from the sale of disposable devices is recognized when a purchase order has been received, the devices have been shipped, the selling price is fixed or determinable, and collection is reasonably assured. Currently, our customers are not required to purchase a minimum number of disposable devices in connection with the purchase of our systems.

Revenue from training services is recorded when an agreement with the customer exists for such training, the training services have been provided, and collection is reasonably assured.

Revenue from service support contracts is recognized on a straight-line basis over the term of the contract, which approximates recognizing it as it is earned.

Revenue from equipment rental under an operating lease is recognized when billed in accordance with the lease agreement.

Our revenue recognition policy is the same for sales to both related parties and non-related parties. We provide the same products and services under the same terms for non-related parties as with related parties.

Sales to distributors are recognized in the same manner as sales to end-user customers.

Deferred revenue and customer deposits include amounts from service contracts as well as cash received for the sales of products, which have not been shipped.

Inventory Reserves: We maintain a reserve for obsolete inventories to reduce excess and obsolete inventories to their estimated net realizable value. This reserve is a significant estimate and we periodically review our inventory levels and usage, paying particular attention to slower-moving items. If projected sales do not materialize or if our systems do not receive increased market acceptance, we may be required to increase the reserve for obsolete inventories in future periods.

Product Warranty: We provide limited product warranties on our systems. These warranties vary from contract to contract, but generally consist of parts and labor warranties for one year from the date of installation. To date, expenses resulting from such warranties have not been material. We record a warranty expense at the time of each sale. This reserve is estimated based on prior history of service expense associated with similar units sold in the past.

Allowance for Doubtful Accounts: We maintain an allowance for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. This allowance is a significant estimate and is regularly evaluated by us for adequacy by taking into consideration factors such as past experience, credit quality of the customer base, age of the receivable balances, both individually and in the aggregate, and current economic conditions that may affect a customer's ability to pay. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.

Stock-based Compensation: Stock-based compensation cost of stock options and other stock-based awards to employees and directors is measured at the grant date based on the estimated value of the award granted, using the Black-Scholes option pricing model, and recognized over the period in which the award vests. For stock awards no longer expected to vest, any previously recognized stock compensation expense is reversed in the period of termination. The stock-based compensation expense has been allocated to the various categories of operating costs and expenses in a manner similar to the allocation of payroll expense. The Black-Scholes valuation model utilizes inputs that are subject to change over time, including the volatility of the market price of our common stock, risk free interest rates, requisite service periods and assumptions made by us regarding the assumed life and vesting of stock options and stock-based awards. As new options or stock-based awards are granted, additional non-cash compensation expense will be recorded by us.

Income Taxes: We account for income taxes using the asset and liability method. Under the asset and liability method, deferred tax assets and liabilities are recognized for the future 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 enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

We maintain valuation allowances where it is more likely than not that all or a portion of a deferred tax asset will not be realized. Changes in valuation allowances are included in our income tax provision in the period of change. In determining whether a valuation allowance is warranted, we evaluate factors such as prior earnings history, expected future earnings and our ability to carry back reversing items within two years to offset income taxes previously paid.

To the extent that we have the ability to carry back current period taxable losses to offset income taxes previously paid, we record an income tax receivable and a current income tax benefit.

Recent Accounting Pronouncements

No new accounting pronouncements were adopted during the quarter ended February 28, 2014 that had a material impact on our financial statements. No new accounting pronouncements were issued during the three months ended February 28, 2014 and through the date of filing this report that we believe are applicable or would have a material impact on our financial statements.