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, 2014.

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, 2014, the Company had outstanding 4,208,588 shares of Common Stock, $0.10 par value.

TABLE OF CONTENTS

PART I FINANCIAL INFORMATION

Item 1.	Financial Statements	3
Item 2.	Management s Discussion and Analysis of Financial Condition and Results of Operation	15
Item 3.	Quantitative and Qualitative Disclosures about Market Risk	18
Item 4.	Controls and Procedures	19

PART II - OTHER INFORMATION

Item 1.	Legal Proceedings	20
Item 1A.	Risk Factors	20
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	20
Item 3.	Defaults Upon Senior Securities	20
Item 4.	Mine Safety Disclosure	20
Item 5.	Other Information	20
Item 6.	Exhibits	20

SIGNATURES 21

Table of Contents

PART I FINANCIAL INFORMATION

Item 1. Financial Statements.

MGC DIAGNOSTICS CORPORATION AND SUBSIDIARY
Consolidated Balance Sheets
January 31, 2014 and October 31, 2013
(In thousands, except share and per share data)

	January 31, 2014 (Unaudited)	October 31, 2013
Assets		
Current Assets:		
Cash and cash equivalents	$ 11,104	$ 10,574
Accounts receivable, net of allowance for doubtful accounts of $151 and $147, respectively	5,554	8,048
Inventories, net of obsolescence reserve of $305 and $306, respectively	4,019	3,499
Prepaid expenses and other current assets	1,020	1,102
Total current assets	21,697	23,223
Property and equipment, net of accumulated depreciation of $4,167 and $4,094, respectively	898	779
Intangible assets, net	2,326	2,189
Total Assets	$ 24,921	$ 26,191
Liabilities and Shareholders Equity		
Current Liabilities:		
Accounts payable	$ 1,665	$ 1,871
Employee compensation	1,189	1,945
Deferred revenue	3,092	3,091
Other current liabilities and accrued expenses	614	905
Total current liabilities	6,560	7,812
Long-term liabilities:		
Long-term deferred revenue and other	2,630	2,535
Total Liabilities	9,190	10,347
Commitments and Contingencies		
Shareholders Equity:		
Common stock, $0.10 par value, authorized 25,000,000 shares, 4,210,863 and 4,193,990 shares issued and 4,145,436 and 4,127,896 shares outstanding in 2014 and 2013, respectively	415	413
Undesignated shares, authorized 5,000,000 shares, no shares issued and outstanding		
Additional paid-in capital	22,729	22,606
Accumulated deficit	(7,413)	(7,175)
Total Shareholders Equity	15,731	15,844
Total Liabilities and Shareholders Equity	$ 24,921	$ 26,191

See accompanying notes to consolidated financial statements.

Table of Contents

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

	Three Months ended January 31, 2014		Three Months ended January 31, 2013	
Revenues				
Equipment, supplies and accessories revenues	$	4,959	$	5,806
Service revenues		1,345		1,202
		6,304		7,008
Cost of revenues				
Cost of equipment, supplies and accessories revenues		2,300		2,835
Cost of service revenues		440		351
		2,740		3,186
Gross margin		3,564		3,822
Operating expenses:				
Selling and marketing		2,016		2,126
General and administrative		1,143		1,418
Research and development		624		647
Amortization of intangibles		7		7
		3,790		4,198
Loss before taxes		(226)		(376)
Provision for taxes		17		7
Net loss	$	(243)	$	(383)
Loss per share:				
Basic	$	(0.06)	$	(0.10)
Diluted	$	(0.06)	$	(0.10)
Weighted average common shares outstanding:				
Basic		4,135		3,891
Diluted		4,135		3,891

See accompanying notes to consolidated financial statements.

Table of Contents

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

	Three Months ended January 31, 2014	Three Months ended January 31, 2013
Cash flows from operating activities:		
Net loss	$ (243)	$ (383)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation	75	55
Amortization	35	21
Stock-based compensation	127	101
Increase in allowance for doubtful accounts	4	7
Decrease in inventory obsolescence reserve	(1)	21
(Gain) loss on disposal of equipment		(3)
Changes in operating assets and liabilities:		
Accounts receivable	2,490	(176)
Inventories	(516)	(207)
Prepaid expenses and other current assets	82	120
Accounts payable	(206)	(88)
Employee compensation	(756)	(256)
Deferred revenue	75	314
Other current liabilities and accrued expenses	(286)	(10)
Net cash provided by (used in) operating activities	880	(484)
Cash flows from investing activities:		
Purchases of property and equipment and intangible assets	(369)	(317)
Net cash used in investing activities	(369)	(317)
Cash flows from financing activities:		
Proceeds from issuance of common stock under employee stock purchase plan	67	68
Repurchase of common stock upon vesting of restricted stock awards	(48)	(10)
Net cash provided by financing activities	19	58
Net increase (decrease) in cash and cash equivalents	530	(743)
Cash and cash equivalents at beginning of period	10,574	9,665
Cash and cash equivalents at end of period	$ 11,104	$ 8,922
Cash paid for taxes	$ 53	$ 16
Supplemental non-cash items:		
Current and non-current liabilities issued for leasehold improvements	$	$ 210

See accompanying notes to consolidated financial statements.

Table of Contents

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, 2014, the consolidated statements of income (loss) for the three months ended January 31, 2014 and 2013, the consolidated statements of cash flows for the three months ended January 31, 2014 and 2013 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, 2013 was derived from the audited consolidated financial statements as of that date. Operating results for the three months ended January 31, 2014 are not necessarily indicative of the results that may be expected for the year ending October 31, 2014. 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, 2013.

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, 2014, 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 distributors. 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. When appropriate, infrequent customer requested short-term bill-and-hold arrangements are accommodated and accounted for in accordance with authoritative literature. Sales and use taxes are reported on a net basis, excluding them from revenues and cost of revenues.

Table of Contents

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 five years. Deferred income associated with service contracts was $5,155,000 and $4,974,000 as of January 31, 2014 and October 31, 2013, 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 $311,000 and $411,000 as of January 31, 2014 and October 31, 2013, 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 are met. Deferred revenue from the allocation of discounts within multiple deliverable sale agreements was $79,000 as of January 31, 2014 and October 31, 2013. 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, 2014 and 2013.

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 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 $41,000 and $37,000 as of January 31, 2014 and October 31, 2013, 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 Breeze Suite platform, including underlying support products. Capitalized software may also include other less significant projects supporting software for separate sale or for internal use.

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. Costs for internal use software are amortized over the expected use periods of the software (See Note 5). 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.

Table of Contents

(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 income (loss) for the three months ended January 31, 2014 and 2013 was $127,000 and $101,000, respectively.

Stock Options

A summary of the Company s stock activity for the three months ended January 31, 2014 and 2013 is presented in the following table:

	For the Three Months ended			
	January 31, 2014		January 31, 2013	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding at beginning of period	110,370	$ 6.83	286,072	$ 6.57
Granted			5,900	6.76
Expired or cancelled	(500)	6.76	(13,502)	6.81
Outstanding at end of period	109,870	$ 6.83	278,470	$ 6.56

The following table summarizes information concerning stock options outstanding as of January 31, 2014:

Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life	Number Subject to Exercise
$ 5.08	4,500	2.32	4,500
5.16	20,250	1.57	20,250
6.23	14,000	0.74	14,000
6.60	13,295	0.55	13,295
6.76	5,400	8.79	1,796
7.86	52,425	0.75	52,425
Total	109,870	1.33	106,266

The total intrinsic value of options outstanding and exercisable as of January 31, 2014 was $471,000 and $455,000, respectively, which was calculated using the closing stock price at the end of the first quarter less the option price of in-the-money options. The Company issues new shares when stock options are exercised. Unrecognized compensation expense related to outstanding stock options as of January 31, 2014 was $17,000 and is expected to be recognized over a weighted average period of 1.78 years.

Valuation Assumptions

The Company uses the Black-Scholes option-pricing model (Black-Scholes model) to determine the fair value of stock options as of the grant date. The fair value of stock options under the Black-Scholes model requires management to make assumptions regarding projected employee stock option exercise behaviors, risk-free interest rates, volatility of the Company s stock price and expected dividends. The expense recognized for options granted under the 2002 Plan and 2007 Plan is equal to the fair value of stock options as of the grant date.

Table of Contents

Restricted Stock Awards

Restricted stock awards are awards of common stock that are subject to restrictions on transfer and to a risk of forfeiture if the holder leaves the Company before the restrictions lapse. The holder of a restricted stock award is generally entitled at all times on and after the date of issuance of the restricted shares to exercise the rights of a shareholder of the Company, including the right to vote the shares. The value of stock awards that vest over time was established by the market price on the date of its grant. A summary of the Company s restricted stock activity for the three months ended January 31, 2014 and 2013 is presented in the following table:

	For the Three Months ended			
	January 31, 2014		January 31, 2013	
	Shares	Weighted Average Grant Date Fair Value	Shares	Weighted Average Grant Date Fair Value
Unvested at beginning of period	66,094	$ 5.88	101,071	$ 5.23
Granted			2,000	5.80
Vested	(667)	5.80	(4,000)	5.10
Unvested at end of period	65,427	$ 5.88	99,071	$ 5.24