

FONAR CORP  
Form 10-Q  
November 09, 2016

FORM 10-Q

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended SEPTEMBER 30, 2016

Commission file number 0-10248

FONAR CORPORATION

(Exact name of registrant as specified in its charter)

DELAWARE	11-2464137
(State or other jurisdiction of	(I.R.S. Employer
incorporation or organization)	Identification No.)
110 Marcus Drive Melville, New York	11747
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code: (631) 694-2929

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

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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 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 definition of accelerated filer, large accelerated filer or smaller reporting 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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the close of the latest practicable date.

<u>Class</u>	<u>Outstanding at November 4, 2016</u>
Common Stock, par value \$.0001	6,158,073
Class B Common Stock, par value \$.0001	146
Class C Common Stock, par value \$.0001	382,513
Class A Preferred Stock, par value \$.0001	313,438

FONAR CORPORATION AND SUBSIDIARIES

INDEX

	PAGE
<b>PART I - FINANCIAL INFORMATION</b>	
Item 1. Financial Statements	3
Condensed Consolidated Balance Sheets - September 30, 2016 (Unaudited) and June 30, 2016	3
Condensed Consolidated Statements of Income for the Three Months Ended September 30, 2016 and September 30, 2015 (Unaudited)	6
Condensed Consolidated Statements of Cash Flows for the Three Months Ended September 30, 2016 and September 30, 2015 (Unaudited)	7
Notes to Condensed Consolidated Financial Statements (Unaudited)	8
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	19
Item 3. Quantitative and Qualitative Disclosures About Market Risk	28
Item 4. Controls and Procedures	28
<b>PART II - OTHER INFORMATION</b>	29
Item 1. Legal Proceedings	29
Item 1A. Risk Factors	29
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	32
Item 3. Defaults Upon Senior Securities	32
Item 4. Mine Safety Disclosures	32
Item 5. Other Information	32
Item 6. Exhibits	32
Signatures	33

## FONAR CORPORATION AND SUBSIDIARIES

## CONDENSED CONSOLIDATED BALANCE SHEETS

(Amounts and shares in thousands, except per share amounts)

(UNAUDITED)

## ASSETS

	September 30, 2016	June 30, 2016 *
Current Assets:		
Cash and cash equivalents	\$ 7,994	\$ 8,528
Accounts receivable – net	4,604	4,370
Accounts receivable - related party	90	—
Medical receivable – net	10,547	10,127
Management and other fees receivable - net	16,560	15,638
Management and other fees receivable – related medical practices – net	4,232	4,064
Inventories	2,214	2,074
Prepaid expenses and other current assets	722	759
Total Current Assets	46,963	45,560
Deferred income tax asset	13,042	13,042
Property and equipment – net	14,563	14,513
Goodwill	3,322	3,322
Other intangible assets – net	7,456	7,719
Other assets	794	732
Total Assets	\$ 86,140	\$ 84,888

\*Condensed from audited financial statements.

See accompanying notes to condensed consolidated financial statements.

## FONAR CORPORATION AND SUBSIDIARIES

## CONDENSED CONSOLIDATED BALANCE SHEETS

(Amounts and shares in thousands, except per share amounts)

(UNAUDITED)

## LIABILITIES AND STOCKHOLDERS' EQUITY

	September 30, 2016	June 30, 2016 *
Current Liabilities:		
Current portion of long-term debt and capital leases	\$ 2,436	\$ 2,448
Accounts payable	1,304	1,254
Other current liabilities	8,269	10,827
Unearned revenue on service contracts	4,936	4,679
Unearned revenue on service contracts – related party	83	—
Customer deposits	1,067	1,199
Billings in excess of costs and estimated earnings on uncompleted contracts	176	207
Total Current Liabilities	18,271	20,614
Long-Term Liabilities:		
Deferred income tax liability	482	482
Due to related medical practices	236	245
Long-term debt and capital leases, less current portion	661	2,059
Other liabilities	803	712
Total Long-Term Liabilities	2,182	3,498
Total Liabilities	20,453	24,112

\*Condensed from audited financial statements.

See accompanying notes to condensed consolidated financial statements.



## FONAR CORPORATION AND SUBSIDIARIES

## CONDENSED CONSOLIDATED BALANCE SHEETS

(Amounts and shares in thousands, except per share amounts)

(UNAUDITED)

## LIABILITIES AND STOCKHOLDERS' EQUITY (Continued)

STOCKHOLDERS' EQUITY:	September 30, 2016	June 30, 2016 *
Class A non-voting preferred stock \$.0001 par value; 453 shares authorized at September 30, 2016 and June 30, 2016, 313 issued and outstanding at September 30, 2016 and June 30, 2016	\$—	\$—
Preferred stock \$.001 par value; 567 shares authorized at September 30, 2016 and June 30, 2016, issued and outstanding – none	—	—
Common Stock \$.0001 par value; 8,500 shares authorized at September 30, 2016 and June 30, 2016, 6,170 and 6,062 issued at September 30, 2016 and June 30, 2016, respectively; 6,158 and 6,051 outstanding at September 30, 2016 and June 30, 2016, respectively	1	1
Class B Common Stock (10 votes per share) \$.0001 par value; 227 shares authorized at September 30, 2016 and June 30, 2016; .146 issued and outstanding at September 30, 2016 and June 30, 2016	—	—
Class C Common Stock (25 votes per share) \$.0001 par value; 567 shares authorized at September 30, 2016 and June 30, 2016, 383 issued and outstanding at September 30, 2016 and June 30, 2016	—	—
Paid-in capital in excess of par value	175,948	173,702
Accumulated deficit	(117,053)	(120,624)
Notes receivable from employee stockholders	(22 )	(24 )
Treasury stock, at cost - 12 shares of common stock at September 30, 2016 and June 30, 2016	(675 )	(675 )
Total Fonar Corporation Stockholder Equity	58,199	52,380
Noncontrolling interests	7,488	8,396
Total Stockholders' Equity	65,687	60,776
Total Liabilities and Stockholders' Equity	\$86,140	\$84,888

\*Condensed from audited financial statements.

See accompanying notes to condensed consolidated financial statements.





## FONAR CORPORATION AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(Amounts and shares in thousands, except per share amounts)

(UNAUDITED)

	FOR THE THREE MONTHS ENDED SEPTEMBER 30,	
	2016	2015
REVENUES		
Product sales – net	\$242	\$18
Service and repair fees – net	2,351	2,284
Service and repair fees - related parties – net	28	28
Patient fee revenue, net of contractual allowances and discounts	8,823	8,114
Provision for bad debts for patient fee	(3,878 )	(3,507 )
Management and other fees – net	9,261	8,829
Management and other fees - related medical practices – net	1,907	1,845
Total Revenues – Net	18,734	17,611
COSTS AND EXPENSES		
Costs related to product sales	213	112
Costs related to service and repair fees	655	543
Costs related to service and repair fees - related parties	8	7
Costs related to patient fee revenue	2,414	2,228
Costs related to management and other fees	5,261	5,419
Costs related to management and other fees – related medical practices	953	1,058
Research and development	412	436
Selling, general and administrative	4,065	4,193
Total Costs and Expenses	13,981	13,996
Income From Operations	4,753	3,615
Interest Expense	(98 )	(150 )
Investment Income	48	50
Other Expense	(3 )	—
Income Before Provision for Income Taxes and Noncontrolling Interests	4,700	3,515
Provision for Income Taxes	200	50
Net Income	4,500	3,465
Net Income - Noncontrolling Interests	(929 )	(603 )
Net Income - Controlling Interests	\$3,571	\$2,862
Net Income Available to Common Stockholders	\$3,343	\$2,676
Net Income Available to Class A Non-Voting Preferred Stockholders	\$170	\$139
Net Income Available to Class C Common Stockholders	\$58	\$47
Basic Net Income Per Common Share Available to Common Stockholders	\$0.55	\$0.44
Diluted Net Income Per Common Share Available to Common Stockholders	\$0.54	\$0.43
Basic and Diluted Income Per Share – Class C Common	\$0.15	\$0.12
Weighted Average Basic Shares Outstanding – Common Stockholders	6,105	6,050
Weighted Average Diluted Shares Outstanding - Common Stockholders	6,233	6,178

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Weighted Average Basic Shares Outstanding – Class C Common	383	383
Weighted Average Diluted Shares Outstanding – Class C Common	383	383

See accompanying notes to condensed consolidated financial statements.

Page 6

## FONAR CORPORATION AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Amounts and shares in thousands, except per share amounts)

(UNAUDITED)

	FOR THE THREE MONTHS ENDED SEPTEMBER 30,	
	2016	2015
Cash Flows from Operating Activities:		
Net income	\$4,500	\$3,465
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	856	829
Provision for bad debts	(161 )	418
Compensatory element of stock issuances	7	—
Stock issued for costs and expenses	2,239	—
(Increase) decrease in operating assets, net:		
Accounts, medical and management fee receivable(s)	(1,675)	(2,186 )
Notes receivable	12	11
Inventories	(140 )	(104 )
Prepaid expenses and other current assets	26	73
Other assets	(63 )	12
Increase (decrease) in operating liabilities, net:		
Accounts payable	50	(187 )
Other current liabilities	(2,218)	1,120
Customer deposits	(132 )	1
Billings in excess of costs and estimated earnings on uncompleted contracts	(30 )	—
Other liabilities	92	16
Due to related medical practices	(9 )	(4 )
Net cash provided by operating activities	3,354	3,464
Cash Flows from Investing Activities:		
Purchases of property and equipment	(599 )	(45 )
Cost of patents	(43 )	(19 )
Net cash used in investing activities	(642 )	(64 )
Cash Flows from Financing Activities:		
Repayment of borrowings and capital lease obligations	(1,410)	(623 )
Distributions to noncontrolling interests	(1,837)	(1,255 )
Repayment of notes receivable from employee stockholders	1	2
Net cash used in financing activities	(3,246)	(1,876 )
Net (Decrease) Increase in Cash and Cash Equivalents	(534 )	1,524
Cash and Cash Equivalents - Beginning of Period	8,528	9,449
Cash and Cash Equivalents - End of Period	\$7,994	\$10,973

See accompanying notes to condensed consolidated financial statements.

Page 7

FONAR CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2016 and 2015

(Amounts and shares in thousands, except per share amounts)

(UNAUDITED)

NOTE 1 – DESCRIPTION OF BUSINESS AND BASIS OF PRESENTATION

Description of Business

-

Effective July 1, 2015, the Company restructured the corporate organization of the management of diagnostic imaging centers segment of our business. The reorganization was structured to more completely integrate the operations of Health Management Corporation of America and HDM. Imperial contributed all of its assets (which were utilized in the business of Health Management Corporation of America) to HDM and received a 24.2% interest in HDM. Health Management Corporation of America retained a direct ownership interest of 45.8% in HDM, and the original investors in HDM retained a 30.0% ownership interest in the newly expanded HDM. The entire management of diagnostic imaging centers business segment is now being conducted by HDM, operating under the name “Health Management Company of America”.

Basis of Presentation

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The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three months ended September 30, 2016, are not necessarily indicative of the results that may be expected for the fiscal year ending June 30, 2017. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's Annual Report on Form 10-K filed on September 28, 2016 for the fiscal year ended June 30, 2016.

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

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The unaudited condensed consolidated financial statements include the accounts of FONAR Corporation, its majority and wholly-owned subsidiaries and partnerships (collectively the “Company”). All significant intercompany accounts and transactions have been eliminated in consolidation.

Earnings Per Share

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Basic earnings per share (“EPS”) is computed based upon the weighted average number of shares of common stock and stock equivalents outstanding, net of common stock. In accordance with ASC topic 260-10, “Participating Securities and the Two-Class method”, the Company used the Two-Class method for calculating basic income per share and applied the if converted method in calculating diluted income per share for the three months ended September 30, 2016 and 2015.

Diluted EPS reflects the potential dilution from the exercise or conversion of all dilutive securities into common stock based on the average market price of common shares outstanding during the period. For the three months ended September 30, 2016 and 2015, diluted EPS for common shareholders includes 128 shares upon conversion of Class C Common.

FONAR CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2016 and 2015

(Amounts and shares in thousands, except per share amounts)

(UNAUDITED)

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Earnings Per Share (Continued)

	Three months ended September 30, 2016			Three months ended September 30, 2015		
	Total	Common Stock	Class C Common Stock	Total	Common Stock	Class C Common Stock
<u>Basic</u>						
<u>Numerator:</u>						
Net income available to common stockholders	\$3,571	\$ 3,343	\$ 58	\$2,862	\$2,676	\$ 47
<u>Denominator:</u>						
Weighted average shares outstanding	6,105	6,105	383	6,050	6,050	383
Basic income per common share	\$0.58	\$ 0.55	\$ 0.15	\$0.47	\$ 0.44	\$ 0.12
<u>Diluted</u>						
<u>Denominator:</u>						
Weighted average shares outstanding		6,105	383		6,050	383
Convertible Class C Stock		128	—		128	—
Total Denominator for diluted earnings per share		6,233	383		6,178	383
Diluted income per common share		\$ 0.54	\$ 0.15		\$ 0.43	\$ 0.12





FONAR CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2016 and 2015

(Amounts and shares in thousands, except per share amounts)

(UNAUDITED)

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Recent Accounting Pronouncements

-

In March 2016, the FASB issued ASU No. 2016-09, "Compensation-Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting". This update includes provisions intended to simplify various aspects of accounting for share-based compensation. ASU No. 2016-09 will take effect for public companies for the annual periods beginning after December 15, 2016. The Company is currently assessing the potential impact of ASU No. 2016-09 on the Company's consolidated condensed financial statements.

During February 2016, FAS issued ASU 2016-02, Leases (Topic 842). The new standard requires lessees to apply a dual approach, classifying leases as either finance or operating leases based upon the principle of whether or not the lease is effectively a financed purchase by the lessee. This classification will determine whether lease expense is recognized based on an effective interest method or on a straight-line basis over the term of the lease. A lessee is also required to record a right-of-use asset and a lease liability for all leases with a term of greater than 12 months regardless of their classification. Lease with a term of 12 months or less will be accounted for similar to existing guidance for operating leases. The new guidance will be effective for annual reporting periods beginning after December 15, 2018, including interim periods within that reporting period and is applied retrospectively. Early adoption is permitted. The Company is currently in the process of assessing the impact the adoption of this guidance will have on the Company's consolidated condensed financial statements.

The FASB has issued ASU No. 2014-09, Revenue from Contracts with Customers. This ASU supercedes the revenue recognition requirements in Accounting Standards Codification 605 - Revenue Recognition and most industry-specific guidance throughout the Codification. The standard requires that an entity recognizes revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services. This ASU is effective for annual reporting periods beginning after December 15, 2017, including interim periods within the reporting period and should be applied retrospectively to

each prior reporting period presented or retrospectively with the cumulative effect of initially applying the ASU recognized at the date of initial application. The Company is currently evaluating the effect that this ASU will have on its consolidated financial statements and related disclosures. The Company has not yet selected a transition method nor has it determined the effect of the standard on its ongoing financial reporting.

In July 2015, the FASB issued Accounting Standards Update No. 2015-11, "Simplifying the Measurement of Inventory" ("ASU 2015-11"). ASU 2015-11 requires an entity to measure inventory at the lower of cost and net realizable value. Net realizable value is the estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. Subsequent measurement is unchanged for inventory measured using last-in, first-out ("LIFO") or the retail inventory method. It is effective for annual reporting periods beginning after December 15, 2016. The amendments should be applied prospectively with earlier application permitted as of the beginning of an interim or annual reporting period.

FASB, the Emerging Issues Task Force and the SEC have issued certain other accounting standards, updates, and regulations as of September 30, 2016 that will become effective in subsequent periods; however, management does not believe that any of those updates would have significantly affected our financial accounting measures or disclosures had they been in effect during 2016 or 2015, and it does not believe that any of those pronouncements will have a significant impact on our consolidated financial statements at the time they become effective.

### Reclassifications

Certain prior year amounts have been reclassified to conform to the current year presentation. The reclassifications did not have any effect on reported consolidated net income for any periods presented.

## FONAR CORPORATION AND SUBSIDIARIES

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2016 and 2015

(Amounts and shares in thousands, except per share amounts)

(UNAUDITED)

## NOTE 3 – ACCOUNTS RECEIVABLE, MEDICAL RECEIVABLE AND MANAGEMENT AND OTHER FEES RECEIVABLE

Accounts Receivable, Medical Receivable and Management and Other Fees Receivable

Receivables, net is comprised of the following September 30, 2016, and June 30, 2016:

	September 30, 2016		
	Gross Receivable	Allowance for doubtful accounts	Net
Accounts receivable	\$4,888	\$284	\$4,604
Accounts receivable - related party	\$90	—	\$90
Medical receivable	\$28,752	\$18,205	\$10,547
Management and other fees receivable	\$29,469	\$12,909	\$16,560
Management and other fees receivable from related medical practices ("PC's")	\$4,625	\$393	\$4,232
	June 30, 2016		
	Gross Receivable	Allowance for doubtful accounts	Net
Accounts receivable	\$4,654	\$284	\$4,370
Accounts receivable - related party	\$—	—	\$—
Medical receivable	\$27,579	\$17,452	\$10,127
Management and other fees receivable	\$29,584	\$13,946	\$15,638
Management and other fees receivable from related medical practices ("PC's")	\$4,457	\$393	\$4,064

The Company's customers are concentrated in the healthcare industry.

Accounts Receivable

Credit risk with respect to the Company's accounts receivable related to product sales and service and repair fees is limited due to the customer advances received prior to the commencement of work performed and the billing of amounts to customers as sub-assemblies are completed. Service and repair fees are billed on a monthly or quarterly basis and the Company does not continue providing these services if accounts receivable become past due. The Company controls credit risk with respect to accounts receivable from service and repair fees through its credit evaluation process, credit limits, monitoring procedures and reasonably short collection terms. The Company performs ongoing credit authorizations before a product sales contract is entered into or service and repair fees are provided.

FONAR CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2016 and 2015

(Amounts and shares in thousands, except per share amounts)

(UNAUDITED)

NOTE 3 – ACCOUNTS RECEIVABLE, MEDICAL RECEIVABLE AND MANAGEMENT AND OTHER FEES RECEIVABLE (CONTINUED)

Medical Receivables

Medical receivables are due under fee-for-service contracts from third party payors, such as hospitals, government sponsored healthcare programs, patient's legal counsel and directly from patients. Substantially all the revenue relates to patients residing in Florida. The carrying amount of the medical receivable is reduced by an allowance that reflects management's best estimate of the amounts that will not be collected. The Company continuously monitors collections from its clients and maintains an allowance for bad debts based upon the Company's historical collection experience. The Company determines allowances for contractual adjustments and uncollectible accounts based on specific agings, specific payor collection issues that have been identified and based on payor classifications and historical experience at each site.

Management and Other Fees Receivable

The Company's receivables from the related and non-related professional corporations (PC's) substantially consist of fees outstanding under management agreements. Payment of the outstanding fees is dependent on collection by the PC's of fees from third party medical reimbursement organizations, principally insurance companies and health management organizations.

Payment of the management fee receivables from the PC's may be impaired by the inability of the PC's to collect in a timely manner their medical fees from the third party payors, particularly insurance carriers covering automobile no-fault and workers compensation claims due to longer payment cycles and rigorous informational requirements and certain other disallowed claims. Approximately 64% and 60% of the PC's' net revenues for the three months ended

September 30, 2016 and 2015, respectively, were derived from no-fault and personal injury protection claims. The Company considers the aging of its accounts receivable in determining the amount of allowance for doubtful accounts. The Company generally takes all legally available steps to collect its receivables. Credit losses associated with the receivables are provided for in the condensed consolidated financial statements and have historically been within management's expectations.

Net revenues from management and other fees charged to the related PCs accounted for approximately 10.2% and 10.5% of the consolidated net revenues for the three months ended September 30, 2016 and 2015, respectively.

Tallahassee Magnetic Resonance Imaging, PA, Stand Up MRI of Boca Raton, PA and Stand Up MRI & Diagnostic Center, PA (all related medical practices) entered into a guaranty agreement, pursuant to which they cross guaranteed all management fees which are payable to the Company, which have arisen under each individual management agreement.

The Company's patient fee revenue, net of contractual allowances and discounts less the provision for bad debts for the three months ended September 30, 2016 and 2015 are summarized in the following table.

	For the Three Months Ended September 30,	
	2016	2015
Commercial Insurance/ Managed Care	\$1,264	\$1,071
Medicare/Medicaid	300	275
Workers' Compensation/Personal Injury	5,680	5,308
Other	1,579	1,460
Patient Fee Revenue, net of contractual allowances and discounts	8,823	8,114
Provision for Bad Debts	(3,878)	(3,507)
Net Patient Fee for Revenue	\$4,945	\$4,607

FONAR CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2016 and 2015

(Amounts and shares in thousands, except per share amounts)

(UNAUDITED)

NOTE 4 - INVENTORIES

Inventories included in the accompanying condensed consolidated balance sheets consist of the following:

	September 30, 2016	June 30, 2016
Purchased parts, components and supplies	\$ 1,984	\$1,862
Work-in-process	230	212
TOTAL INVENTORIES	\$ 2,214	\$2,074

NOTE 5 - COSTS AND ESTIMATED EARNINGS ON UNCOMPLETED CONTRACTS

Information relating to uncompleted contracts is as follows:

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	September 30, 2016	June 30, 2016
Costs incurred on uncompleted contracts	\$ 837	\$894
Estimated earnings	480	491
Subtotal	1,317	1,385
Less: Billings to date	1,493	1,592
Total Costs and estimated earnings in excess of billings on uncompleted contracts	\$ (176 )	\$(207 )

Included in the accompanying condensed consolidated balance sheets under the following captions:

	September 30, 2016	June 30, 2016
Costs and estimated earnings in excess of billings on uncompleted contracts	\$ —	\$—
Less: Billings in excess of costs and estimated earnings on uncompleted contracts	(176 )	(207)
Total Costs and estimated earnings in excess of billings on uncompleted contracts	\$ (176 )	(207)



FONAR CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2016 and 2015

(Amounts and shares in thousands, except per share amounts)

(UNAUDITED)

NOTE 6 – OTHER INTANGIBLE ASSETS

Other intangible assets, net of accumulated amortization, in the accompanying condensed consolidated balance sheets consist of the following:

	September 30, 2016	June 30, 2016
Capitalized software development costs	\$ 7,005	\$ 7,005
Patents and copyrights	4,614	4,571
Non-compete	4,100	4,100
Customer relationships	3,800	3,800
Gross Other intangible assets	19,519	19,476
Less: Accumulated amortization	12,063	11,757
Other Intangible Assets	\$ 7,456	\$ 7,719

Amortization of patents and copyrights for the three months ended September 30, 2016 and 2015 amounted to \$47 and \$47, respectively.

Amortization of capitalized software development costs for the three months ended September 30, 2016 and 2015 amounted to \$65 and \$81, respectively.

Amortization of non-compete for the three months ended September 30, 2016 and 2015 amounted to \$146 and \$146, respectively.

Amortization of customer relationships for the three months ended September 30, 2016 and 2015 amounted to \$48 and \$48, respectively.

NOTE 7 – OTHER CURRENT LIABILITIES

Other current liabilities in the accompanying condensed consolidated balance sheets consist of the following:

	September 30, 2016	June 30, 2016
Accrued salaries, commissions and payroll taxes	\$ 860	\$3,189
Accrued interest	45	45
Litigation accruals	545	545
Sales tax payable	2,387	2,403
Legal and other professional fees	370	385
Accounting fees	123	241
Self-funded health insurance reserve	9	392
Interest and penalty - sales tax	2,517	2,487
Other	1,413	1,140
Other Current Liabilities	\$ 8,269	\$10,827

FONAR CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2016 and 2015

(Amounts and shares in thousands, except per share amounts)

(UNAUDITED)

NOTE 8 – STOCKHOLDERS EQUITY

Common Stock

During the three months ended September 30, 2016, the Company issued .3 shares of common stock to employees and consultants as compensation valued at \$7 under a stock bonus plan.

During the three months ended September 30, 2016, the Company issued 107 shares of common stock for costs and expenses of \$2,239.

NOTE 9 – BUSINESS COMBINATIONS

Acquisitions

On June 30, 2016, the Company purchased 100% interest in TK2 Equipment Management, LLC and Turnkey Services of New York, LLC. The consideration and net assets acquired is as follows:

Cash Paid	\$4,224
Net assets at Fair Value	2,862
Goodwill	\$1,555

Pro forma Results

The following unaudited pro forma results of operations for the three months ended September 30, 2015 assumes that the above acquisitions were made at the beginning of the year prior to acquisition. The unaudited pro forma information does not purport to be indicative of the results that would have been obtained if the acquisitions had actually occurred at the beginning of the year prior to acquisition, nor of the results that may be reported in the future.

	Three months ended September 30, 2015
Total Revenues – Net	17,611
Net Income - Controlling Interests	2,953
Net Income Available to Common Stockholders	2,761
Net Income Available to Class A Non-Voting Preferred Stockholders	143
Net Income Available to Class C Common Stockholders	49
Basic Net Income Per Common Share Available to Common Stockholders	0.46
Diluted Net Income Per Common Share Available to Common Stockholders	0.45
Basic and Diluted Income Per Share - Common C	0.13
Weighted Average Basic Shares Outstanding	6,051
Weighted Average Diluted Shares Outstanding	6,179
Weighted Average Basic and Diluted Shares Outstanding - Class C Common	383

## FONAR CORPORATION AND SUBSIDIARIES

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2016 and 2015

(Amounts and shares in thousands, except per share amounts)

(UNAUDITED)

## NOTE 10 - SEGMENT AND RELATED INFORMATION

The Company operates in two industry segments - manufacturing and the servicing of medical equipment and management of diagnostic imaging centers.

The accounting policies of the segments are the same as those described in the summary of significant accounting policies as disclosed in the Company's 10-K as of June 30, 2016. All inter-segment sales are market-based. The Company evaluates performance based on income or loss from operations.

Summarized financial information concerning the Company's reportable segments is shown in the following table:

	Medical Equipment	Management Of Diagnostic Imaging Centers	Totals
<u>For the three months ended Sept. 30, 2016</u>			
Net revenues from external customers	\$ 2,621	\$ 16,113	\$18,734
Inter-segment net revenues	\$ 381	\$ —	\$381
(Loss) Income from operations	\$ (147 )	\$ 4,900	\$4,753
Depreciation and amortization	\$ 80	\$ 776	\$856
Capital expenditures	\$ 43	\$ 599	\$642
<u>For the three months ended Sept. 30, 2015</u>			
Net revenues from external customers	\$ 2,330	\$ 15,281	\$17,611
Inter-segment net revenues	\$ 524	\$ —	\$524
(Loss) Income from operations	\$ (63 )	\$ 3,678	\$3,615
Depreciation and amortization	\$ 78	\$ 751	\$829

Capital expenditures	\$ 19	\$ 45	\$ 64
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NOTE 11 – SUPPLEMENTAL CASH FLOW INFORMATION

During the three months ended September 30, 2016 and September 30, 2015, the Company paid \$67 and \$102 for interest, respectively.

During the three months ended September 30, 2016 and September 30, 2015, the Company paid \$200 and \$50 for income taxes, respectively.

FONAR CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2016 and 2015

(Amounts and shares in thousands, except per share amounts)

(UNAUDITED)

NOTE 12 – COMMITMENTS AND CONTINGENCIES

Litigation

The Company is subject to legal proceedings and claims arising from the ordinary course of its business, including personal injury, customer contract and employment claims. In the opinion of management, the aggregate liability, if any, with respect to such actions, will not have a material adverse effect on the consolidated financial position or results of operations of the Company.

There were no material changes in litigation from that reported in our Form 10-K for the fiscal year ended June 30, 2016.

Other Matters

The Company is also delinquent in filing sales tax returns for certain states, for which the Company has transacted business. As of September 30, 2016, the Company has recorded tax obligations of approximately \$2,387 plus interest and penalties of approximately \$2,517. The Company is in the process of determining the regulatory requirements in order to become compliant.

The Company maintains a self-funded health insurance program with a stop-loss umbrella policy with a third party insurer to limit the maximum potential liability for individual claims to \$100 per person and for a maximum potential

claim liability based on member enrollment. With respect to this program, the Company considers historical and projected medical utilization data when estimating its health insurance program liability and related expense. As of September 30, 2016 and June 30, 2016, the Company had approximately \$9 and \$392, respectively, in reserve for its self-funded health insurance programs. The reserves are included in "Other current liabilities" in the condensed consolidated balance sheets.

The Company regularly analyzes its reserves for incurred but not reported claims, and for reported but not paid claims related to its reinsurance and self-funded insurance programs. The Company believes its reserves are adequate. However, significant judgment is involved in assessing these reserves such as assessing historical paid claims, average lags between the claims' incurred date, reported dates and paid dates, and the frequency and severity of claims. There may be differences between actual settlement amounts and recorded reserves and any resulting adjustments are included in expense once a probable amount is known. There were no significant adjustments recorded in the periods covered by this report.



FONAR CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2016 and 2015

(Amounts and shares in thousands, except per share amounts)

(UNAUDITED)

NOTE 13 - INCOME TAXES

ASC topic 740 prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of tax positions taken or expected to be taken in a corporate tax return. For those benefits to be recognized, a tax position must be more-likely-than-not to be sustained upon examination by taxing authorities. Differences between tax positions taken or expected to be taken in a tax return and the benefit recognized and measured pursuant to the interpretation are referred to as unrecognized benefits. A liability is recognized (or amount of net operating loss carryforward or amount of tax refundable is reduced) for an unrecognized tax benefit because it represents an enterprise's potential future obligation to the taxing authority for a tax position that was not recognized as a result of applying the provisions of ASC topic 740.

In accordance with ASC topic 740, interest costs related to unrecognized tax benefits are required to be calculated (if applicable) and would be classified as "Interest expense, net". Penalties if incurred would be recognized as a component of "Selling, general and administrative" expenses.

The Company files corporate income tax returns in the United States (federal) and in various state and local jurisdictions. In most instances, the Company is no longer subject to federal, state and local income tax examinations by tax authorities for years prior to 2010.

The Company has recorded a deferred tax asset of \$13,042 and a deferred tax liability of \$482 as of September 30, 2016, primarily relating to net operating loss carryforwards of approximately \$110,029 available to offset future taxable income through 2031. The net operating losses begin to expire in 2021 for federal tax purposes and in 2016 for state income tax purposes.

The ultimate realization of deferred tax assets is dependent on the generation of future taxable income during the periods in which those temporary differences become deductible. The Company considers projected future taxable income and tax planning strategies in making this assessment. At present, the Company believes that it is more likely than not that the benefits from certain NOL carryforwards will not be fully realized. In recognition of this inherent risk, a valuation allowance was established for the partial value of the deferred tax asset.

A valuation allowance will be maintained until sufficient positive evidence exists to support the reversal of the remainder of the valuation. Should the Company continue to remain profitable in future periods with supportable trends, the valuation allowance will be reversed accordingly.

#### NOTE 14 – SUBSEQUENT EVENTS

The Company has evaluated events that occurred subsequent to September 30, 2016 and through the date the condensed consolidated financial statements were issued.

FONAR CORPORATION AND SUBSIDIARIES

Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

For the three month period ended September 30, 2016, we reported a net income of \$4.5 million on revenues of \$18.7 million as compared to net income of \$3.5 million on revenues of \$17.6 million for the three month period ended September 30, 2015. Operating income increased 31.5% from \$3.6 million for the three month period ended September 30, 2015 to \$4.8 million for the three month period ended September 30, 2016.

The revenue increase of 6.4%, from \$17.6 million for the first three months of fiscal 2016 to \$18.7 million for the first three months of fiscal 2017, was primarily due to an increase in patient fee revenue (net of contractual allowances and discounts) from \$4.6 million for the first three months of fiscal 2016 to \$4.9 million for the first three months of fiscal 2017 and increases in net management fees of \$494,000, from \$10.7 million for the first three months of fiscal 2016 to \$11.2 million for the first three months of fiscal 2017. Revenues from product sales and service repair fees also increased from the first three months of fiscal 2016 to the first three months of fiscal 2017, by \$224,000 and \$67,000 respectively.

While our revenues increased, our costs and expenses remained constant, resulting in an operating income of \$4.7 million for the three months ended September 30, 2016, compared to our operating income of \$3.5 million for the three months ended September 30, 2015. In terms of percentages, costs and expenses remained constant at \$13.9 million in the first three months of fiscal 2016 and in the first three months of fiscal 2017, while revenues increased 6.4%, from \$17.6 million in the first three months of fiscal 2016 to \$18.7 million in the first three months of fiscal 2017.

Fonar's wholly-owned subsidiary, Health Management Corporation of America ("HMCA"), is the controlling, but not sole owner of two limited liability companies, Imperial Management Services, LLC ("Imperial") and Health Diagnostics Management, LLC ("HDM"). Effective July 1, 2015, the Company restructured the corporate organization of the management of diagnostic imaging centers segment of the business. The reorganization was structured to more completely integrate the operations of HMCA and HDM. Imperial Management Services LLC contributed all of its assets (which had been utilized in the business of HMCA) to HDM and received a 24.2% interest in HDM. HMCA retained a direct ownership interest of 45.8% in HDM, and the original investors in HDM retained a 30.0% ownership interest in the newly expanded HDM. The entire management of the diagnostic imaging centers business segment is now being conducted by HDM, operating under the name "Health Management Company of America". For the sake of simplicity, HMCA, Imperial and HDM are referred to as "HMCA", unless otherwise indicated.

## FONAR CORPORATION AND SUBSIDIARIES

### Forward Looking Statements

Certain statements made in this Quarterly Report on Form 10-Q are "forward-looking statements" (within the meaning of the Private Securities Litigation Reform Act of 1995) regarding the plans and objectives of Management for future operations. Such statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, performance or achievements to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements. The forward-looking statements included herein are based on current expectations that involve numerous risks and uncertainties. Our plans and objectives are based, in part, on assumptions involving the expansion of business. Assumptions relating to the foregoing involve judgments with respect to, among other things, future economic, competitive and market conditions and future business decisions, all of which are difficult or impossible to predict accurately and many of which are beyond our control. Although we believe that our assumptions underlying the forward-looking statements are reasonable, any of the assumptions could prove inaccurate and, therefore, there can be no assurance that the forward-looking statements included in this Report will prove to be accurate. In light of the significant uncertainties inherent in the forward-looking statement included herein, the inclusion of such information should not be regarded as a representation by us or any other person that our objectives and plans will be achieved.

### Results of Operations

We operate in two industry segments: the manufacture and servicing of medical (MRI) equipment, our traditional business, which is conducted directly by Fonar, and diagnostic facilities management services, which is conducted through HMCA and its subsidiaries.

#### Manufacturing and Service of MRI Equipment

Revenues from MRI product sales increased to \$242,000 for the first three months of fiscal 2017 from \$18,000 for the first three months of fiscal 2016. Costs related to product sales also increased, from \$112,000 for the three month period ended September 30, 2015 to \$213,000 for the three month period ended September 30, 2016. The increase in sales revenues, reflects the volatility resulting from low sales volume. Continuing tight credit and economic uncertainty, together with lower reimbursement rates for MRI scans, have depressed the market for our MRI scanner products.

Service revenues increased 2.9% from \$2.3 million for the three month period ended September 30, 2015 to \$2.4 million for the three month period ended September 30, 2016. Continuing lower sales volumes have been a factor ultimately contributing to the small increase in service revenues, as the number of older scanners being taken out of service has been greater than the number of new scanners being placed under service agreements following the expiration of their warranties.

## FONAR CORPORATION AND SUBSIDIARIES

Costs relating to providing service for the first three months of fiscal 2017 increased by 20.5% from \$550,000 in the first three months of fiscal 2016 to \$663,000 in the first three months of fiscal 2017. We believe that an important factor in controlling our service costs is our ability to monitor the performance of customers' scanners from our facilities in Melville, New York on a daily basis, and to detect and repair any irregularities before more serious problems result.

There were approximately \$194,000 in foreign revenues for the first three months of fiscal 2017 as compared to approximately \$150,000 in foreign revenues for the first three months of fiscal 2016, representing an increase in foreign revenues of 29.3%. We do not regard this as a material trend, but as part of a normal although sometimes volatile variation resulting from low volumes of foreign sales.

We recognize MRI scanner sales revenues on the "percentage of completion" basis, which means the revenues are recognized as the scanner is manufactured. Revenues recognized in a particular quarter do not necessarily reflect new orders or progress payments made by customers in that quarter. We build the scanner as the customer meets certain benchmarks in its site preparation in order to minimize the time lag between incurring costs of manufacturing and our receipt of the cash progress payments from the customer which are due upon delivery. Consequently, there can be a disparity between the revenues recognized in a fiscal period and the number of product sales. Generally, the revenues from a scanner sale are recognized in a fiscal quarter or quarters following the quarter in which the sale was made.

Revenues for the medical equipment segment as a whole increased by 12.5% to \$2.6 million for the three months of fiscal 2017 from \$2.3 million for the first three months of fiscal 2016. Operating results for our medical equipment segment decreased to an operating loss of \$147,000 for the first three months of fiscal 2017 as compared to an operating loss of \$63,000 for the first three months of fiscal 2016.

### Diagnostic Facilities Management Services

HMCA revenues increased in the first three months of fiscal 2017 by 5.4% to \$16.1 million from \$15.3 million for the first three months of fiscal 2016. The percentage of our revenues derived from our diagnostic facilities management segment relative to the percentage of our revenues derived from our medical equipment segment decreased slightly to 86.0% for the first three months of fiscal 2017, from 86.8% for the first three months of fiscal 2016.

The increase in HMCA revenues is principally due to HMCA's success in marketing the scanning services of the facilities managed or owned by HMCA, notwithstanding the decrease in reimbursement rates paid for MRI scans by insurers, Medicare and other government programs. The reductions in reimbursement rates are not unique to HMCA or HMCA's clients but are being experienced by the industry in general.

## FONAR CORPORATION AND SUBSIDIARIES

HMCA's efforts are countering the effects of lower reimbursement rates by increasing the scan volume of the facilities it owns or manages.

As a result of our vigorous marketing efforts, the number of scans performed at our centers and at our client's centers increased from 38,238 in the first three months of fiscal 2016 to 39,725 in the first three months of fiscal 2017.

We manage twenty-five sites, twenty-four of which are equipped with Fonar Upright® MRI scanners (our Upright® MRI Scanners are also called Stand-Up® MRI Scanners). HMCA experienced an operating income of \$4.9 million for the first three months of fiscal 2017 compared to operating income of \$3.7 million for the first three months of fiscal 2016.

HMCA's cost of revenues for the first three months of fiscal 2017 as compared to the first three months of fiscal 2016 decreased by 0.9% from \$8.7 million to \$8.6 million.

### Consolidated

For the first three months of fiscal 2016, our consolidated net revenues increased by 6.4% to \$18.7 million from \$17.6 million for the first three months of fiscal 2016, and total costs and expenses remained constant for the first three months of fiscal 2017 and for the first three months of fiscal 2016 at \$13.9 million. As a result, our operating income increased 31.5% to \$4.8 million in the first three months of fiscal 2017 from \$3.6 million in the first three months of fiscal 2016.

Selling, general and administrative expenses decreased by 3.1% to \$4.1 million in the first three months of fiscal 2017 from \$4.2 million in the first three months of fiscal 2016. The compensatory element of stock issuances, which is included in selling, general and administrative expenses, increased, \$6,802 for the first three months of fiscal 2017 from \$0 for the first three months of fiscal 2016.

Research and development expenses decreased by 5.5% to \$412,000 for the first three months of fiscal 2017 from \$436,000 for the first three months of fiscal 2016.

Interest expense in the first three months of fiscal 2017 decreased by 34.7% to \$98,000 from \$150,000 in the first three months of fiscal 2016. The decrease was due to the repayment of debt incurred by Fonar in connection with the acquisition of HDM.

Inventories increased to \$2.2 million at September 30, 2016 from \$2.1 million at June 30, 2016. This represents our use of raw materials and components in our business operations.

Net Management fee and medical receivables increased by 5.0% to \$31.3 million at September 30, 2016 from \$29.8 million at June 30, 2016 as a result of slower collections. The slower collections were primarily due to an increase in no-fault and workers' compensation revenue, which typically takes longer to collect.

## FONAR CORPORATION AND SUBSIDIARIES

The results of operations for the first three months of fiscal 2017 reflect an increase in revenues from management, patient and other fees, as compared to the first three months of fiscal 2016 (\$16.1 million for the first three months of fiscal 2017 as compared to \$15.3 million for the first three months of fiscal 2016), and an increase in MRI equipment segment revenues (\$2.4 million as compared to \$2.3 million). Revenues were 14.0% from the MRI equipment segment as compared to 86.0% from HMCA, for the first three months of fiscal 2017, as compared to 13.3% from the MRI equipment segment and 86.7% from HMCA for the first three months of fiscal 2016.

The implementation of the Patient Protection and Affordable Care Act (PPACA) is having a profound impact on the healthcare industry. We are experiencing some of the impact of the Act on our business in the reduction of reimbursement rates and fewer sales of our MRI equipment, but are unable to predict the ultimate effect of the legislative mandates and regulations on our MRI equipment segment or HMCA segment in the future.

We are committed to improving our operating results and dealing with the challenges posed by legislative and regulatory requirements. Nevertheless, factors beyond our control, such as the timing and rate of market growth, economic conditions, the availability of credit and payor reimbursement rates, or unexpected expenditures and the timing of such expenditures, make it difficult to forecast future operating results.

As mentioned, one of the effects of the PPACA on our business has been the reduction in Medicare reimbursement rates for MRI scans. This also has resulted in a reduction in the reimbursement rates by commercial insurers and government programs which tie their reimbursement rates to the Medicare rates. Nevertheless, the increased patient volume of the scanning centers we manage or own has enabled us to maintain a healthy profitability in spite of these challenges. We believe we are pursuing the correct policies to cope with these problems and to improve the Company's operating results. However, our future revenues and results of operations may be adversely impacted by future reductions in reimbursement rates.

Our Upright® MRI (also referred to as the Stand-Up® MRI), together with our works-in-progress, are intended to significantly improve our competitive position.

## FONAR CORPORATION AND SUBSIDIARIES

The Upright® MRI scanner, which operates at 6000 gauss (.6 Tesla) field strength, allows patients to be scanned while standing, sitting, reclining and in multiple flexion and extension positions. It is common in visualizing the spine that abnormalities are visualized in some positions and not others. This enables surgical corrections that heretofore would be unaddressable for lack of visualizing the symptom causing the pathology and therefore, in general enables the treating physician to achieve a better treatment outcome for his patient. A floor-recessed elevator brings the patient to the height appropriate for the targeted image region. A custom-built multi-position adjustable bed will allow patients to sit or lie on their backs, sides or stomachs at any angle. This allows the MRI technologist to ask the patient to position himself/herself in the exact position that generates his/her pain so that images of the patient in the position that explicitly generates the patient's pain can be nailed down. Full-range-of-motion studies of the joints in virtually any direction are possible, a particularly promising feature for sports injuries.

In addition FONAR has announced the publication of a new book "THE CRANIOCERVICAL SYNDROME and MRI" that highlights the unique attributes of FONAR UPRIGHT® MRI Imaging (S. Karger, A.G. based in Basel, Switzerland- [www.karger.com/Book/Home/261956](http://www.karger.com/Book/Home/261956)) which has been published by S. Karger, a 125 year old company and an academic publisher of scientific and medical journals and books. The seven chapter monograph examines the rapid advances in MRI made possible by the FONAR UPRIGHT® Multi-Position MRI that are transforming the treatment of patients suffering from the craniocervical syndrome (CCS). It is written by leading international experts in the field to practitioners with a better understanding of the subtle anatomy and MRI appearances at the craniocervical junction, along with insight into the clinical significance of cerebrospinal fluid (CSF) flow measurements and its potential role in generating the devastating impairments of the neurodegenerative diseases: Alzheimer's (5.1 million patients in the United States), childhood and adult Autism (3.0 million), Parkinson's (1.0 million), Multiple Sclerosis (250,000-350,000) and Amyotrophic Lateral Sclerosis (ALS) (30,000). It calls attention to the revolutionary importance of FONAR's new UPRIGHT® MRI imaging technology and the prospect of significantly relieving the suffering of the above totaled 9.38 million patients afflicted with these disorders.

Fonar also announced a major diagnostic breakthrough in multiple sclerosis achieved with advanced Upright® MRI. Medical researchers at FONAR published a paper reporting a diagnostic breakthrough in multiple sclerosis (MS), based on observations made possible by the Company's unique Upright® Multi-Position™ MRI scanner. The findings reveal that the cause of multiple sclerosis may be biomechanical and related to earlier trauma to the neck, which can result in obstruction of the flow of cerebrospinal fluid (CSF), which is produced and stored in the central anatomic structures of the brain known as the ventricles. Since the ventricles produce a large net volume of CSF each day (500 cc), the obstruction can result in a build up of pressure within the ventricles, resulting in leakage of the CSF and the antigenic polypeptides it contains into the surrounding brain tissue. This leakage could be responsible for generating the brain lesions of multiple sclerosis.



## FONAR CORPORATION AND SUBSIDIARIES

The paper, titled "The Possible Role of Cranio-Cervical Trauma and Abnormal CSF Hydrodynamics in the Genesis of Multiple Sclerosis," appears in the of the journal *Physiological Chemistry and Physics and Medical NMR* (Sept. 20, 2011).

This capability of the Fonar Upright® technology has demonstrated its key value on patients with the Arnold-Chiari syndrome [Cerebellar Tonsil Extopia (CTE)], which is believed to affect 200,000 to 500,000 Americans. In this syndrome, brain stem compression and subsequent severe neurological symptoms occur in these patients, because the brain stem descends and is compressed at the base of the skull in the foramen magnum, which is the circular bony opening at the base of the skull where the spinal cord exits the skull. Conventional lie-down MRI scanners cannot make an adequate evaluation of this pathology since the patient's pathology is most visible and the symptoms most acute when the patient is scanned in the upright fully weight-bearing position.

A combined study of 1,200 neck pain patients published in "Brain Injury" (July 2010) by eight university medical centers reported that cerebellar tonsil ectopia (CTE) of 1mm or greater was found and visualized 2.5 times (250%) more frequently when patients who had sustained automobile whiplash injuries were scanned upright rather than lying down.

The Upright® MRI has also demonstrated its value for patients suffering from scoliosis. Scoliosis patients have been typically subjected to routine x-ray exams for years and must be imaged upright for an adequate evaluation of their scoliosis. Because the patient must be standing for a complete evaluation of the extent of the patient's scoliosis, an x-ray machine has been the only modality that could provide that service. The Upright® MRI is the only MRI scanner which allows the patient to stand during the MRI exam. Fonar has developed an RF receiver and scanning protocol that for the first time allows scoliosis patients to obtain diagnostic pictures of their spines without the risks of x-rays. A study by the National Cancer Institute (2000) of 5,466 women with scoliosis reported a 70% increase in breast cancer resulting from 24.7 chest x-rays these patients received on the average in the course of their scoliosis treatment. The Upright® MRI examination of scoliosis enables the needed imaging evaluation of the degree of spine scoliosis without exposing the patient to the risk of breast cancer from x-radiation. Currently scoliosis affects more than 3,000,000 American women.

In addition, the University of California, Los Angeles (UCLA) reported their results of their study of 1,302 patients utilizing the Fonar Upright® MRI at the 22nd Annual Meeting of the North American Spine Society on October 23, 2007. The UCLA study showed the superior ability of the Fonar Upright® MRI to detect spine pathology, including spondylolisthesis, disc herniations and disc degeneration, as compared to visualizations of the spine produced by traditional single position static MRIs.

## FONAR CORPORATION AND SUBSIDIARIES

The UCLA study by MRI of 1,302 back pain patients when they were in the Fonar Upright® MRI and examined in a full range of flexion and extension positions made possible by Fonar's new Upright® technology established that significant "misses" of pathology were occurring with static single position MRI imaging. At L4-5, the vertebral level responsible for 49.8% of lumbar disc herniations, 35.1% of the spondylolistheses (vertebral instabilities) visualized by the Upright® MRI, were being missed by static single position MRI (510 patients). Since this vertebral segment is responsible for the majority of all disc herniations, the finding may reveal a significant cause of failed back surgeries. The UCLA study further showed the "miss-rate" of vertebral instabilities by static only MRI was even higher, 38.7%, at the L3-4 vertebral segment. Additionally, the UCLA study showed that MRI examinations of the cervical spine that did not perform extension images of the neck "missed" disc bulges 23.75% of the time (163 patients).

The UCLA study further reported that they were able to quantitatively measure the dimensions of the central spinal canal with the "highest accuracy" using the FONAR Upright® MRI thereby enabling the extent of spinal canal stenosis that existed in patients to be measured. Spinal canal stenosis gives rise to the symptom complex intermittent neurogenic claudication manifest as debilitating pain in the back and lower extremities, weakness and difficulties in ambulation and leg paresthesias. Spinal canal stenosis is a spinal compression syndrome separate and distinct from the more common nerve compression syndrome of the spinal nerves as they exit the vertebral column through the bony neural foramen.

The Fonar Upright® MRI can also be useful for MRI directed emergency neuro-surgical procedures as the surgeon would have unhindered access to the patient's head when the patient is supine with no restrictions in the vertical direction. This easy-entry, mid-field-strength scanner could prove ideal for trauma centers where a quick MRI-screening within the first critical hour of treatment will greatly improve patients' chances for survival and optimize the extent of recovery.

### Liquidity and Capital Resources

Cash and cash equivalents decreased by 6.3% from \$8.5 million at June 30, 2016 to \$8.0 million at September 30, 2016, primarily as a result of the increased purchases of property and equipment.

Cash provided by operating activities for the first three months of fiscal 2017 was \$3.4 million. Cash provided by operating activities was attributable principally to net income of \$4.5 million and depreciation and amortization of \$856,000, offset by an increase in accounts, management fee receivables and medical receivables of \$1.7 million and a decrease in other current liabilities of \$2.2 million.

Cash used in investing activities for the first three months of fiscal 2017 was \$642,000. The principal uses of cash used in investing activities during the first three months of fiscal 2017 consisted of patent costs of \$43,000 and the purchase of property and equipment of \$599,000.

## FONAR CORPORATION AND SUBSIDIARIES

Cash used in financing activities for the first three months of fiscal 2017 was \$3.2 million. The principal uses of cash in financing activities during the first three months of fiscal 2017 were the repayment of principal on long-term debt and capital lease obligations of \$1.4 million and distributions to non-controlling interests of \$1.8 million.

Total liabilities decreased by 15.2% to \$20.5 million at September 30, 2016 from \$24.1 million at June 30, 2015. "Other" current liabilities decreased by 23.6% to \$8.3 million at September 30, 2016 from \$10.8 million at June 30, 2016. Long-term debt and capital lease obligations decreased from \$2.1 million to \$661,000. The current portion of our unearned revenue on service contracts increased from \$4.7 million to \$5.0 million. Customer deposits decreased from \$1.2 million at June 30, 2016 to \$1.1 million at September 30, 2016 as a result of reduced sales.

As of September 30, 2016, the total of \$8.3 million in "other" current liabilities included accrued salaries and payroll taxes of \$860,000, and sales taxes of \$2.4 million plus accrued interest and penalties of \$2.5 million.

Our working capital increased to \$28.7 million at September 30, 2016 from \$24.9 million at June 30, 2016. This resulted from an increase in current assets (\$45.6 million at June 30, 2016 as compared to \$47.0 million at September 30, 2016), and a decrease in current liabilities from \$20.6 million at June 30, 2016 to \$18.3 million at September 30, 2016.

The ultimate realization of deferred tax assets is dependent on the generation of future taxable income during the periods in which those temporary differences become deductible. The Company considers projected future taxable income and tax planning strategies in making this assessment. A valuation allowance will be maintained until sufficient positive evidence exists to support the reversal of any portion or all of the valuation allowance. Should the Company continue to remain profitable in the future periods with supportable trends, the valuation allowance will be reversed accordingly.

Fonar has not committed to making any significant capital expenditures for the remainder of the 2017 fiscal year, except for a new scanner HMCA plans to acquire to provide to a site in Florida presently managed by HMCA.

Critical to our business plan are the improvement and expansion of the MRI facilities managed or owned by HMCA, and increasing the number of scans performed at those facilities. In addition, our business plan calls for a continuing commitment to providing our customers with enhanced equipment service and maintenance capabilities and delivering state-of-the-art, innovative and high quality equipment and upgrades at competitive prices.

In furtherance of our business plan, HMCA began managing a twenty-fifth MRI scanning facility located in Great Neck, New York, in the last week of December, 2015.

## FONAR CORPORATION AND SUBSIDIARIES

Management is seeking to promote wider market recognition of Fonar's scanner products, and to increase demand for Upright® scanning at the facilities HMCA owns or manages. Given the liquidity and credit constraints in the markets, and the uncertainty resulting for the Patient Protection and Affordable Care Act, the sale of medical equipment has and may continue to suffer.

The Company believes that its business plan has been responsible for the past four consecutive fiscal years and past fiscal quarter of profitability (fiscal 2012, fiscal 2013, fiscal 2014, fiscal 2015, fiscal 2016 and the first three months of fiscal 2017) and that its capital resources will be adequate to support operations at current levels through at least September 30, 2017. In the past, the Company experienced periods of working capital deficits and prior to fiscal 2011, losses. The future effects on our business of healthcare reform legislation, the Deficit Reduction Act, the 2.3% excise tax on sales of medical equipment, reimbursement rates and the general economic and business climate are not known at the present time. Nevertheless, there is a possibility of adverse consequences to our business operations from these causes.

### Item 3. Quantitative and Qualitative Disclosures About Market Risk

The Company maintains its funds in liquid accounts. None of our investments are in fixed rate instruments.

All of our revenue, expense and capital purchasing activities are transacted in United States dollars.

### Item 4. Controls and Procedures

#### Disclosure Controls and Procedures

We carried out an evaluation, under the supervision and with the participation of our management, including our chief executive officer and chief financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the Exchange Act is accumulated and communicated to the issuer's management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure. Based upon our evaluation, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures are effective, as of September 30, 2016, in ensuring that material information that we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms.



## FONAR CORPORATION AND SUBSIDIARIES

### Changes in Internal Control over Financial Reporting

There were no changes in our system of internal control over financial reporting during the three months ended September 30, 2016 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## PART II – OTHER INFORMATION

Item 1 – Legal Proceedings: There were no material changes in litigation from that reported in our Form 10-K for the fiscal year ended June 30, 2016.

Item 1A – Risk Factors: An investment in the securities of the Company is subject to various risks, the most significant of which are summarized below.

1. **Reduced Reimbursement Rates.** Most of our revenues are derived from our scanning center business conducted by HMCA. Our scanning center clients and the Florida facilities owned by HMCA are experiencing lower reimbursement rates from Medicare, other government programs and private insurance companies. To date, the impact of these reductions has been countered by increasing scanning volume, thereby maintaining profitability in this business segment. There is, however, no assurance that we will be able to continue to do so.

2. **Demand for MRI Scanners.** The reduced reimbursement rates also affects our sales of MRI scanners negatively. With lower revenue projections, fewer prospective customers will be able to operate and demand lower prices for scanners. Although the reduced reimbursements may not affect foreign demand, a lower number of sales in the aggregate could reduce economies of scale and consequently, profit margins.

## FONAR CORPORATION AND SUBSIDIARIES

3. Manufacturing Competition. Many if not most of our competing scanner manufacturers have significantly greater financial resources, production capacity, and other resources than we do. Such competitors would include General Electric, Siemens, Hitachi and Phillips. Although Fonar is the only company which can manufacture and sell the unique Stand-Up® (Upright®) MRI scanner, potential customers must be convinced that the purchase of a Fonar scanner is their best choice. We believe that with time, that objective will be reached, particularly with customers scanning patients having neck, back, knee and various orthopedic issues who would benefit from being scanned in weight-bearing positions.

4. Dependence on Referrals. HMCA derives substantially all of its revenue, directly or indirectly, from fees charged for the diagnostic imaging services performed at the facilities. We depend on referrals of patients from unaffiliated physicians and other third parties to the facilities we manage or own for the MRI scanning services performed. If these physicians and other third parties were to reduce the number of patients they refer or discontinue referring patients, scan volumes could decrease, which would have the effect of reducing our net revenue, from both management and scanning fees, and operating margins.

5. Pressure to Control Healthcare Costs. One of the principal objectives of health maintenance organizations and preferred provider organizations is to control the cost of healthcare services. Healthcare providers participating in managed care plans may be required to refer diagnostic imaging tests to certain providers depending on the plan in which a covered patient is enrolled. In addition, managed care contracting has become very competitive. The expansion of health maintenance organizations, preferred provider organizations and other managed care organizations within New York or Florida could have a negative impact on the utilization and pricing of services performed at the facilities HMCA manages or owns to the extent these organizations exert control over patients' access to diagnostic imaging services, selections of the provider of such services and reimbursement rates for those services.

6. Scanning Facility Competition. The market for diagnostic imaging services is highly competitive. The facilities we manage or own compete for patients on the basis of reputation, location and the quality of diagnostic imaging services. Groups of radiologists, established hospitals, clinics and other independent organizations that own and operate imaging equipment are the principal competitors.

## FONAR CORPORATION AND SUBSIDIARIES

7. Eligibility Changes to Insurance Programs. Due to potential decreased availability of healthcare through private employers, the number of patients who are uninsured or participate in governmental programs may increase. Healthcare reform legislation will increase the participation of individuals in the Medicaid program in states that elect to participate in the expanded Medicaid coverage. A shift in payor mix from managed care and other private payors to government payors or an increase in the number of uninsured patients may result in a reduction in the rates of reimbursement or an increase in uncollectible receivables or uncompensated care, with a corresponding decrease in net revenue. Changes in the eligibility requirements for governmental programs such as the Medicaid program and state decisions on whether to participate in the expansion of such programs also could increase the number of patients who participate in such programs and the number of uninsured patients. Even for those patients who remain in private insurance plans, changes to those plans could increase patient financial responsibility, resulting in a greater risk of uncollectible receivables. These factors and events could have a material adverse effect on our business, financial condition, and results of operations.

8. A proposal was published by the New York State Workers' Compensation Board ("NYSWCB") in 2014 to change the fee schedule for Workers' Compensation payments. Initially, the fees proposed would be set at approximately 130% of the Medicare fees. This would reduce fees for the most commonly billed radiology procedures by approximately 60%. Further, since the Workers' Compensation fees are coupled with the New York State No Fault Program, radiology providers would suffer similar reductions for No-Fault fees. Although we and the HMCA clients wrote to the NYSWCB to argue against this proposal, and other affected parties commented as well, there can be no assurance that the NYSWCB will withdraw or modify this proposal, or if they elect to do so, the extent to which the NYSWCB would modify their proposal. No further action, however, has been taken by the NYSWCB to advance this proposal for approximately two years. A significant reduction in Workers' Compensation and No-Fault fees could have a material adverse impact on our business.

9. Federal and state privacy and information security laws. We must comply with numerous federal and state laws and regulations governing the collection, dissemination, access, use, security and privacy of PHI, including HIPAA and its implementing privacy and security regulations, as amended by the federal HITECH Act and collectively referred to as HIPAA. If we fail to comply with applicable privacy and security laws, regulations and standards, properly maintain the integrity of our data, protect our proprietary rights to our systems, or defend against cybersecurity attacks, our business, reputation, results of operations, financial position and cash flows could be materially and adversely affected.

Information security risks have significantly increased in recent years in part because of the proliferation of new technologies, the use of the internet and telecommunications technologies to conduct our operations, and the increased sophistication and activities of organized crime, hackers, terrorists and other external parties, including foreign state agents. Our operations rely on the secure processing, transmission and storage of confidential, proprietary and other information in our computer systems and networks.



FONAR CORPORATION AND SUBSIDIARIES

10. Changes in Domestic and Worldwide Economic Conditions. We are subject to risk arising from adverse changes in general domestic and global economic conditions, including recession or economic slowdown and disruption of credit markets. Turbulence and uncertainty in the United States and international markets and economies may adversely affect our liquidity, financial condition, revenues, profitability and business operations generally.

Item 2 – Unregistered Sales of Equity Securities and Use of Proceeds: The Company has not issued any unregistered shares of its Common Stock during the first three months of fiscal 2017.

Item 3 - Defaults Upon Senior Securities: None

Item 4 - Mine Safety Disclosure: Not Applicable

Item 5 - Other Information: None

Item 6 - Exhibits and Reports on Form 8-K:

a) Exhibit 31.1 Certification. See Exhibits

b) Exhibit 32.1 Certification. See Exhibits

c) Report on Form 8-K filed on September 28, 2016, Item 2.02: Results of Operations and Financial Condition for the fiscal year ended June 30, 2016.

Report on Form 8-K filed on June 14, 2016, Item 5.07: Submission of Matters to a Vote of Security Holders.

Report on Form 8-K filed on May 10, 2016, Item 2.02: Results of Operations and Financial Condition for the fiscal quarter ended March 15, 2016.

FONAR CORPORATION AND SUBSIDIARIES

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

FONAR CORPORATION

(Registrant)

By: /s/ Timothy Damadian

Timothy Damadian

President and Principal Executive Officer

/s/ Raymond V. Damadian

Raymond V. Damadian

Chairman of the Board, Treasurer and

Acting Principal Financial Officer

Dated: November 9, 2016

Page 33

