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 December 31, 2012

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: 001-11789

ENCISION INC.

(Exact name of registrant as specified in its charter)

Colorado	**84-1162056**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

6797 Winchester Circle

Boulder, Colorado 80301

(Address of principal executive offices)

(303) 444-2600

(Registrant s telephone number)

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 large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filero	Accelerated filer o
Non-accelerated filero (Do not check if a smaller reporting company)	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

Indicate the number of shares outstanding of each of the issuer s classes of common equity, as of the latest practicable date:

Common Stock, no par value	**8,210,100 Shares**
(Class)	(outstanding at December 31, 2012)

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ENCISION INC.

FORM 10-Q

For the Three Months Ended December 31, 2012

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PART I FINANCIAL INFORMATION

ITEM 1 CONDENSED INTERIM FINANCIAL STATEMENTS

Encision Inc.

Condensed Balance Sheets

(unaudited)

		December 31, 2012		March 31, 2012
ASSETS				
Current assets:				
Cash and cash equivalents	$	472,634	$	564,671
Accounts receivable, net of allowance for doubtful accounts of $5,500 at December 31, 2012 and $15,500 at March 31, 2012		1,095,886		1,427,966
Inventories, net of reserve for obsolescence of $45,000 at December 31, 2012 and $117,000 at March 31, 2012		2,622,438		2,489,008
Prepaid expenses		100,119		28,568
Total current assets		4,291,077		4,510,213
Equipment, at cost:				
Furniture, fixtures and equipment		2,588,404		2,497,471
Customer-site equipment		817,329		819,403
Equipment-in-progress		942,398		777,839
Accumulated depreciation		(2,688,623)		(2,476,004)
Equipment, net		1,659,508		1,618,709
Patents, net of accumulated amortization of $184,962 at December 31, 2012 and $169,084 at March 31, 2012		228,234		272,714
Other assets		9,141		7,415
TOTAL ASSETS	$	6,187,960	$	6,409,051
LIABILITIES AND SHAREHOLDERS EQUITY				
Current liabilities:				
Accounts payable	$	693,499	$	1,039,923
Accrued compensation		404,985		283,366
Other accrued liabilities		421,335		349,136
Total current liabilities		1,519,819		1,672,425
Commitments and contingencies				
Shareholders equity:				
Preferred stock, no par value: 10,000,000 shares authorized; none issued and outstanding				
Common stock and additional paid-in capital, no par value: 100,000,000 shares authorized; 8,210,100 shares issued and outstanding at December 31, 2012 and 7,955,100 at March 31, 2012		21,565,029		21,296,646
Accumulated (deficit)		(16,896,888)		(16,560,020)
Total shareholders equity		4,668,141		4,736,626
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	$	6,187,960	$	6,409,051

The accompanying notes to financial statements are an integral part of these condensed statements.

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Encision Inc.

Condensed Statements of Operations

(Unaudited)

Three Months Ended	December 31, 2012	December 31, 2011
NET REVENUE:		
Product	$ 2,954,849	$ 2,688,625
Service	99,831	478,654
Total Revenue	3,054,680	3,167,279
COST OF REVENUE:		
Product	1,316,962	1,195,418
Service	71,805	230,866
Total Cost of Revenue	1,388,767	1,426,284
GROSS PROFIT	1,665,913	1,740,995
OPERATING EXPENSES:		
Sales and marketing	903,068	1,057,771
General and administrative	384,926	406,933
Research and development	460,765	338,461
Total operating expenses	1,748,759	1,803,165
OPERATING LOSS	(82,846)	(62,170)
Interest income (expense), net	37	(18,789)
Other income, net	327	402
Interest and other income, net	364	(18,387)
LOSS BEFORE PROVISION FOR INCOME TAXES	(82,482)	(80,557)
Provision for income taxes		
NET LOSS	$ (82,482)	$ (80,557)
Net loss per share basic and diluted	$ (0.01)	$ (0.01)
Weighted average shares basic and diluted	8,210,100	6,455,100

The accompanying notes to financial statements are an integral part of these condensed statements.

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Encision Inc.

Condensed Statements of Operations

(Unaudited)

Nine Months Ended		**December 31, 2012**		**December 31, 2011**
NET REVENUE:				
Product	$	8,566,008	$	8,352,200
Service		463,835		1,266,232
Total Revenue		9,029,843		9,618,432
COST OF REVENUE:				
Product		3,691,724		3,981,338
Service		311,572		550,776
Total Cost of Revenue		4,003,296		4,532,114
GROSS PROFIT		5,026,547		5,086,318
OPERATING EXPENSES:				
Sales and marketing		2,715,341		3,308,089
General and administrative		1,352,046		1,288,629
Research and development		1,293,645		1,011,226
Total operating expenses		5,361,032		5,607,944
OPERATING LOSS		(334,485)		(521,626)
Interest expense, net		(1,765)		(49,709)
Other income (expense), net		(618)		1,027
Interest and other income (expense), net		(2,383)		(48,682)
LOSS BEFORE PROVISION FOR INCOME TAXES		(336,868)		(570,308)
Provision for income taxes				
NET LOSS	$	(336,868)	$	(570,308)
Net loss per share basic and diluted	$	(0.04)	$	(0.09)
Weighted average shares basic and diluted		8,196,191		6,455,100

The accompanying notes to financial statements are an integral part of these condensed statements.

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Encision Inc.

Condensed Statements of Cash Flows

(Unaudited)

Nine Months Ended	**December 31, 2012**	**December 31, 2011**
Cash flows from operating activities:		
Net loss	$ (336,868)	$ (570,308)
Adjustments to reconcile loss to net cash provided by operating activities:		
Depreciation and amortization	228,497	195,216
Impairment of patent costs	42,212	
Stock-based compensation expense related to stock options	46,164	54,507
Provision for doubtful accounts, net	(10,000)	(4,000)
Provision for inventory obsolescence, net	(72,000)	
Change in operating assets and liabilities:		
Accounts receivable	342,080	(262,758)
Inventories	(61,430)	(73,135)
Prepaid expenses and other assets	(73,277)	22,963
Accounts payable	(346,424)	442,431
Accrued compensation and other accrued liabilities	193,818	327,134
Net cash (used in) operating activities	(47,228)	132,050
Cash flows from investing activities:		
Acquisition of property and equipment	(253,418)	(547,517)
Patent costs	(13,610)	(19,551)
Net cash (used in) investing activities	(267,028)	(567,068)
Cash flows from financing activities:		
Borrowings from credit facility		321,237
Proceeds from the issuance of common stock	255,000	
Cost of the issuance of common stock	(32,781)	
Net cash provided by financing activities	222,219	321,237
Net decrease in cash and cash equivalents	(92,037)	(113,781)
Cash and cash equivalents, beginning of period	564,671	120,008
Cash and cash equivalents, end of period	$ 472,634	$ 6,227

The accompanying notes to financial statements are an integral part of these condensed statements.

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ENCISION INC.

NOTES TO CONDENSED INTERIM FINANCIAL STATEMENTS

DECEMBER 31, 2012

(Unaudited)

Note 1. ORGANIZATION AND NATURE OF BUSINESS

Encision Inc. is a medical device company that designs, develops, manufactures and markets patented surgical instruments that provide greater safety to patients undergoing minimally-invasive surgery. We believe that our patented AEM® (Active Electrode Monitoring) surgical instrument technology is changing the marketplace for electrosurgical devices and instruments by providing a solution to a patient safety risk in laparoscopic surgery. Our sales to date have been made principally in the United States.

We have an accumulated deficit of $16,896,888 at December 31, 2012. Operating funds have been provided primarily by issuances of our common stock and warrants, and the exercise of stock options to purchase our common stock. Should our liquidity be diminished in the future because of operating losses, we may be required to seek additional capital in the future. There are no assurances that additional capital will be available to us on terms acceptable to us, or at all.

Our strategic marketing and sales plan is designed to expand the use of our products in surgically active hospitals and surgery centers in the United States.

Note 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation. The condensed interim financial statements included herein have been prepared by us, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles accepted in the United States (GAAP) have been condensed or omitted pursuant to such rules and regulations, although we believe that the disclosures made are adequate to make the information presented not misleading. The condensed interim financial statements and notes thereto should be read in conjunction with the financial statements and the notes thereto included in our Annual Report on Form 10-K for the fiscal year ended March 31, 2012, filed on May 16, 2012.

The accompanying condensed interim financial statements have been prepared, in all material respects, in conformity with the standards of accounting measurements and reflect, in the opinion of management, all adjustments necessary to summarize fairly the financial position and

results of operations for such periods in accordance with GAAP. All adjustments are of a normal recurring nature. The results of operations for the most recent interim period are not necessarily indicative of the results to be expected for the full year.

Use of Estimates in the Preparation of Financial Statements. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions. Such estimates and assumptions affect the reported amounts of assets and liabilities as well as disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of sales and expense during the reporting period. Actual results could differ from those estimates.

Cash and Cash Equivalents. For purposes of reporting cash flows, we consider all cash and highly liquid investments with an original maturity of three months or less to be cash equivalents.

Fair Value of Financial Instruments. Our financial instruments consist of cash and cash equivalents, short-term trade receivables and payables and a line of credit. The carrying values of cash and cash equivalents, short-term trade receivables and payables approximate their fair value due to their short maturities. The interest rate associated with the line of credit is variable and based upon fluctuations of the prime rate, thus the carrying value approximates fair value.

Concentration of Credit Risk. Financial instruments, which potentially subject us to concentrations of credit risk, consist of cash and cash equivalents, accounts receivable and a line of credit. The amount of cash on deposit with financial institutions exceeds the $250,000 federally insured limit at December 31, 2012. We believe that cash on deposit that exceeds $250,000 with financial institutions is financially sound and the risk of loss is minimal.

We have no significant off-balance sheet concentrations of credit risk such as foreign exchange contracts, options contracts or other foreign hedging arrangements. We maintain the majority of our cash balances with one financial institution in the form of demand deposits.

Accounts receivable are typically unsecured and are derived from transactions with and from entities in the healthcare industry primarily located in the United States. Accordingly, we may be exposed to credit risk generally associated with the healthcare industry. We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. The net accounts receivable balance at December 31, 2012 of $1,095,886 included 5% from one customer. The net accounts receivable balance at March 31, 2012 of $1,427,966 included 17% from one customer.

Warranty Accrual. We provide for the estimated cost of product warranties at the time sales are recognized. While we engage in extensive product quality programs and processes, including actively monitoring and evaluating the quality of our component suppliers, our warranty obligation is based upon historical experience and is also affected by product failure rates and material usage incurred in correcting a product failure. Should actual product failure rates or material usage costs differ from our estimates, revisions to the estimated warranty liability would be required.

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Inventories. Inventories are stated at the lower of cost (first-in, first-out basis) or market. We reduce inventory for estimated obsolete or unmarketable inventory equal to the difference between the cost of inventory and the estimated market value based upon assumptions about future demand and market conditions. If actual market conditions are less favorable than those projected by management, additional inventory write-downs may be required. At December 31, 2012 and March 31, 2012, inventory consisted of the following:

	December 31, 2012	March 31, 2012
Raw materials	$ 1,867,962	$ 1,603,231
Finished goods	799,476	1,002,777
Total gross inventories	2,667,438	2,606,008
Less reserve for obsolescence	(45,000)	(117,000)
Total net inventories	$ 2,622,438	$ 2,489,008

Property and Equipment. Property and equipment are stated at cost, with depreciation computed over the estimated useful lives of the assets, generally three to seven years. We use the straight-line method of depreciation for property and equipment. Leasehold improvements are depreciated over the shorter of the remaining lease term or the estimated useful life of the asset. Maintenance and repairs are expensed as incurred and major additions, replacements and improvements are capitalized.

Long-Lived Assets. Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. A long-lived asset is considered impaired when estimated future cash flows related to the asset, undiscounted and without interest, are insufficient to recover the carrying amount of the asset. If deemed impaired, the long-lived asset is reduced to its estimated fair value. Long-lived assets to be disposed of are reported at the lower of their carrying amount or estimated fair value less cost to sell.

Patents. The costs of applying for patents are capitalized and amortized on a straight-line basis over the lesser of the patent s economic or legal life (20 years from the date of application in the United States). Capitalized costs are expensed if patents are not issued. We review the carrying value of our patents periodically to determine whether the patents have continuing value and such reviews could result in the conclusion that the recorded amounts have been impaired.

Income Taxes. We account for income taxes under the provisions of FASB Accounting Standards Codification (ASC) Topic 740, Accounting for Income Taxes (ASC 740). ASC 740 requires recognition of deferred income tax assets and liabilities for the expected future income tax consequences, based on enacted tax laws, of temporary differences between the financial reporting and tax bases of assets and liabilities. ASC 740 also requires recognition of deferred tax assets for the expected future tax effects of all deductible temporary differences, loss carryforwards and tax credit carryforwards. Deferred tax assets are then reduced, if deemed necessary, by a valuation allowance for the amount of any tax benefits which, more likely than not based on current circumstances, are not expected to be realized. As a result, no provision for income tax is reflected in the accompanying statements of operations. Should we achieve sufficient, sustained income in the future, we may conclude that some or all of the valuation allowance should be reversed. We are required to make many subjective assumptions and judgments regarding our income tax exposures. At December 31, 2012, we had no unrecognized tax benefits, which would affect the effective tax rate if recognized and had no accrued interest, or penalties related to uncertain tax positions.

Revenue Recognition. Revenue from product sales is recorded when we ship the product and title has passed to the customer, provided that we have evidence of a customer arrangement and can conclude that collection is probable. Our shipping policy is FOB Shipping Point. We recognize revenue from sales to stocking distributors when there is no right of return, other than for normal warranty claims. We have no ongoing obligations related to product sales, except for normal warranty obligations. Revenue from engineering services is recognized when the

service is performed.

Research and Development Expenses. We expense research and development costs for products and processes as incurred.

Stock-Based Compensation. Stock-based compensation is presented in accordance with the guidance of ASC Topic 718, Compensation Stock Compensation (ASC 718). Under the provisions of ASC 718, companies are required to estimate the fair value of share-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in our statements of operations.

Stock-based compensation expense recognized under ASC 718 for the three months ended December 31, 2012 and 2011 was $15,375 and $10,166, respectively, and $46,164 and $54,507 for the nine months ended December 31, 2012 and 2011, respectively, which consisted of stock-based compensation expense related to grants of employee stock options.

Segment Reporting. We have concluded that we have one operating segment.

Recent Accounting Pronouncements. We have reviewed all recently issued, but not yet effective, accounting pronouncements and do not believe the future adoption of any such pronouncements may be expected to cause a material impact on our financial condition or the results of our operations.

Note 3. BASIC AND DILUTED INCOME AND LOSS PER COMMON SHARE

We report both basic and diluted net income (loss) per share. Basic net income or loss per common share is computed by dividing net income or loss for the period by the weighted average number of common shares outstanding for the period. Diluted net income or loss per common share is computed by dividing the net income or loss for the period by the weighted average number of common and potential common shares outstanding during the period if the effect of the potential common shares is dilutive. The shares used in the calculation of dilutive potential common shares exclude options to purchase shares where the exercise price was greater than the average market price of common shares for the period.

The following table presents the calculation of basic and diluted net loss per share:

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	Three Months Ended		Nine Months Ended	
	December 31, 2012	December 31, 2011	December 31, 2012	December 31, 2011
Net loss	$ (82,482)	$ (80,557)	$ (336,868)	$ (570,308)
Weighted-average shares basic	8,210,100	6,455,100	8,196,191	6,455,100
Effect of dilutive potential common shares				
Weighted-average shares diluted	8,210,100	6,455,100	8,196,191	6,455,100
Net income loss per share basic	$ (0.01)	$ (0.01)	$ (0.04)	$ (0.09)
Net income loss per share diluted	$ (0.01)	$ (0.01)	$ (0.04)	$ (0.09)
Antidilutive employee stock options	502,000	725,000	502,000	725,000

Note 4. COMMITMENTS AND CONTINGENCIES

We currently lease our facilities at 6797 Winchester Circle, Boulder, Colorado under noncancelable lease agreements through July 31, 2014. The minimum future lease payment, by fiscal year, as of December 31, 2012 is as follows:

Fiscal Year	Amount
2013 (three months remaining)	75,368
2014	320,080
2015	108,303
Total	$ 503,751

Our minimum future equipment lease payments with General Electric Capital Corporation as of December 31, 2012, by fiscal year, are as follows:

Fiscal Year	Amount
2013 (three months remaining)	25,469
2014	8,488
Total	$ 33,957

On May 10, 2012, we signed an amendment to our credit facility agreement with Silicon Valley Bank, effective May 10, 2012. The terms of the credit facility include a line of credit for $2,000,000 for two years at an interest rate calculated at the prime rate plus 1.25%, subject to increase upon a default. Our borrowing under the credit facility is limited by our eligible receivables and inventory at the time of borrowing. The credit facility is secured by all tangible and intangible assets, whether now owned or hereafter acquired, wherever located.

Aside from the operating leases, we do not have any material contractual commitments requiring settlement in the future.

We are subject to regulation by the United States Food and Drug Administration (FDA). The FDA provides regulations governing the manufacture and sale of our products and regularly inspects us and other manufacturers to determine compliance with these regulations. We

believe that we were in substantial compliance with all known regulations as of December 31, 2012. FDA inspections are conducted periodically at the discretion of the FDA. Our latest inspection by the FDA occurred in December 2012.

Note 5. SHARE-BASED COMPENSATION

The provisions of ASC 718-10-55 requires the measurement and recognition of compensation expense for all share-based payment awards made to our employees and directors, including employee stock options, based on estimated fair values. The following table summarizes stock-based compensation expense related to employee stock options and employee stock purchases for the three and nine months ended December 31, 2012 and 2011, which was allocated as follows:

	Three Months Ended		Nine Months Ended	
	December 31, 2012	December 31, 2011	December 31, 2012	December 31, 2011
Cost of sales	$ 684	$ 734	$ 2,054	$ 2,202
Sales and marketing	591	(2,447)	1,773	2,577
General and administrative	11,310	9,029	33,970	41,177
Research and development	2,790	2,850	8,367	8,551
Stock-based compensation expense	$ 15,375	$ 10,166	$ 46,164	$ 54,507

The Black-Scholes model requires the use of actual employee exercise behavior data and the application of a number of assumptions, including expected volatility, risk-free interest rate and expected dividends. There were 2,000 and 47,000 stock options granted during the three and nine months ended December 31, 2012, respectively. There were 240,000 and 260,000 stock options forfeited during the three and nine months ended December 31, 2012, respectively.

As of December 31, 2012, $280,000 of total unrecognized compensation costs related to nonvested stock options is expected to be recognized over a period of five years.

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Note 6. RELATED PARTY TRANSACTIONS

We paid consulting fees of $17,543 and $56,355 to an entity owned by one of our directors during the three and nine months ended December 31, 2012 and $17,969 and $59,260 during the three and nine months ended December 31, 2011, respectively. We paid consulting fees of $5,465 and $77,072 to an entity owned by another director during the three and nine months ended December 31, 2012, respectively, and none for the three and nine months ended December 31, 2011.

Note 7. SUBSEQUENT EVENTS

We evaluated all of our activity and concluded that no subsequent events have occurred that would require recognition in our financial statements or disclosed in the notes to our financial statements.

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ITEM 2 MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Certain statements contained in this section on Management s Discussion and Analysis are not historical facts, including statements about our strategies and expectations with respect to new and existing products, market demand, acceptance of new and existing products, marketing efforts, technologies and opportunities, market and industry segment growth, and return on investments in products and markets. These statements are forward looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 and involve substantial risks and uncertainties that may cause actual results to differ materially from those indicated by the forward looking statements. All forward looking statements in this section on Management s Discussion and Analysis are based on information available to us on the date of this document, and we assume no obligation to update such forward looking statements. Readers of this Form 10-Q are strongly encouraged to review the section entitled *Risk Factors* in our Form 10-K for the fiscal year ended March 31, 2012.

General

Encision Inc., a medical device company based in Boulder, Colorado, has developed and markets innovative technology that provides unprecedented outcomes and patient safety in minimally-invasive surgery. We believe that our patented Active Electrode Monitoring® (AEM) Surgical Instruments are changing the marketplace for electrosurgical devices and laparoscopic instruments by providing a solution to a well-documented hazard unique to laparoscopic surgery.

We address market opportunities created by the increase in minimally-invasive surgery (MIS) and surgeons use of electrosurgery devices in these procedures. The product opportunity exists in that monopolar electrosurgery instruments used in laparoscopic procedures provide excellent clinical results, but are also susceptible to causing inadvertent collateral tissue damage outside the surgeon s field of view. The risk of unintended electrosurgical burn injury to the patient in laparoscopic surgery has been well documented. This risk poses a threat to patient safety, including the risk of death, and creates liability exposure for surgeons and hospitals, as well as increased and preventable readmissions. On October 1, 2012, the Centers for Medicare and Medicaid Services, as part of the Affordable Care Act, began the Readmissions Reduction Program that penalizes hospitals for excessive readmissions in selected clinical areas.

Our patented AEM technology provides surgeons with the desired tissue effects, while preventing stray electrosurgical energy that can cause unintended and unseen tissue injury that may result in death. AEM Surgical Instruments are equivalent to conventional instruments in size, shape, ergonomics, functionality and competitive pricing, but they incorporate Active Electrode Monitoring technology to dynamically and continuously monitor the flow of electrosurgical current, thereby helping to prevent patient injury. With our shielded and monitored instruments, surgeons are able to perform electrosurgical procedures more safely, effectively and economically than is possible using conventional instruments.

AEM technology has been recommended and endorsed by many groups involved in MIS. Surgeons, nurses, biomedical engineers, the medicolegal community, malpractice insurance carriers and electrosurgical device manufacturers advocate the use of AEM technology.

We have focused our marketing strategies to date on expanding the market awareness of the AEM technology and our broad independent endorsements and have continued efforts to improve and expand the AEM product line. Accordingly, we are updating our accepted AEM instruments to include ergonomics and user functionalities for which surgeons have been expressing a preference. When a hospital or surgery

center changes to AEM technology, we receive recurring sales from sales of replacement instruments. We believe that there is no directly competing technology to supplant AEM products. The replacement market of reusable and disposable AEM products in hospitals and surgery centers that use our AEM technology represented over 90% of our sales during the three and nine months ended December 31, 2012. This sales stream is expected to grow as the base of accounts that switch to AEM technology grows. In addition, we intend to develop disposable versions of more of our AEM products in order to meet market demands and expand our sales opportunities.

We have an accumulated deficit of $16,896,888 at December 31, 2012. Operating funds have been provided primarily by issuances of our common stock and warrants and the exercise of stock options to purchase our common stock. Should our liquidity be diminished in the future because of operating losses, we may be required to seek additional capital in the future.

During the nine months ended December 31, 2012, we used $47,228 of cash in our operations and used $253,418 for investments in property and equipment. As of December 31, 2012, we had $472,634 in cash and cash equivalents available to fund future operations, a decrease of $92,037 from March 31, 2012. Our working capital was $2,771,258 at December 31, 2012 compared to $2,837,788 at March 31, 2012.

Historical Perspective

We were organized in 1991 and spent several years developing the AEM monitoring system and protective sheaths to adapt to conventional electrosurgical instruments. During this period, we conducted product trials and applied for patents with the United States Patent Office and international patent agencies. Patents, which are not expired, were issued to us by the United States Patent and Trademark Office in 1998, 1999, 2002, 2007, 2008 and 2011.

As we evolved, it was clear to us that our active electrode monitoring technology needed to be integrated into the standard laparoscopic instrument design. As the development program proceeded, it also became apparent that the merging of electrical and mechanical engineering skills in the instrument development process for our patented, integrated electrosurgical instruments was a complex and difficult task. As a result, instruments with integrated AEM technology were not completed for several years. Prior to offering a full range of laparoscopic electrosurgical instrumentation, it was difficult for hospitals to commit to the AEM solution, as we did not have adequate comparable surgical instrument options to match surgeon demand.

With the broader array of AEM instruments now available, the surgeon has a wide choice of instrument options and does not have to change surgical technique to use our AEM products. Since conversion to AEM technology is transparent to the surgeon, hospitals can convert more easily to AEM technology, thus providing all of their laparoscopic surgery patients a higher level of safety. This development coincides with the continued expansion of independent endorsements for AEM technology. Recommendations from the malpractice insurance and medicolegal communities complement the broad clinical endorsements that AEM technology has garnered over the past few years, leading to increased awareness for the benefits of the technology.

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We continue our focus on developing next generation versions of our AEM instruments to better meet market demands, particularly the demand for improved ergonomics and simplified user functionalities.

Outlook

Installed Base of AEM Monitoring Equipment: We believe that sales of our installed base of AEM products will increase as the inherent risks associated with monopolar laparoscopic electrosurgery become more widely acknowledged, as we focus on increasing our sales efficiency and with recent quality enhancements to our product line, including an improved disposable foot-activated fixed-tip electrode and an enhanced disposable scissor insert, the e-Edge Scissor, which we began shipping in mid-September. We expect that the replacement sales of electrosurgical instruments and accessories will also increase as additional facilities adopt AEM technology. We anticipate that the efforts to improve the productivity of sales representatives carrying the AEM product line, along with the introduction of next generation products, may provide the basis for increased sales and profitable operations. However, these measures, or any others that we may adopt, may not result in either increased sales or profitable operations.

We believe that the unique performance of the AEM technology and our breadth of independent endorsements provide an opportunity for continued market share growth. In our view, market awareness and awareness of the clinical credibility of the AEM technology, as well as awareness of our endorsements, are continually improving, and we expect this awareness to benefit our sales efforts for the remainder of fiscal year 2013. Our objectives in the remainder of fiscal year 2013 are to optimize sales execution, to expand market awareness of the AEM technology and to maximize the number of additional hospital and surgery center accounts switching to AEM instruments while retaining existing customers. In addition, acceptance of AEM products depends on surgeons preference for our instruments, which depends on factors such as ergonomics quality and ease of use in addition to the technological and safety advantages of AEM products. If surgeons prefer other instruments to our instruments, our business results will suffer.

As part of the Affordable Care Act that was enacted in 2009, medical device companies will be required to pay a tax of 2.3 percent of the sales price on medical device sales beginning January 1, 2013. The tax is not imposed on devices sold for further manufacture or devices sold for export. We expect most of our product revenue will be subject to the tax.

Possibility of Operating Losses: We have an accumulated deficit of $16,896,888 at December 31, 2012. Operating funds have been provided primarily by issuances of our common stock and warrants, and the exercise of stock options to purchase our common stock. Should our liquidity be diminished in the future because of operating losses, we may be required to seek additional capital. We have made strides toward improving our operating results but due to the ongoing need to develop, optimize and train our direct sales managers and the independent sales representative network, the need to support the development of refinements to our product line, and the need to increase sustained sales to a level adequate to cover fixed and variable operating costs, we may operate at a net loss. Sustained losses, or our inability to generate sufficient cash flow from operations to fund our obligations, may result in a need to raise additional capital.

Revenue Growth: We expect to generate increased product revenue in the U.S. from sales to new customers and from expanded sales to existing customers as the medical device industry stabilizes and our network of direct and independent sales representatives becomes more efficient. We believe that the visibility and credibility of the independent clinical endorsements for AEM technology will contribute to new accounts and increased product revenue in fiscal year 2013. We also expect to increase market share through promotional programs, including placing our AEM monitors at no charge into hospitals that commit to standardize with AEM instruments. However, all of these efforts to increase market share and grow product revenue will depend in part on our ability to expand the efficiency and effective coverage range of our direct and independent sales representatives, as well as maintain and in some cases, improve the quality of our product offerings.

Service revenue represents design and development service revenue from our agreements with strategic partners. As a result of a project that has been phased out by a strategic partner, and unless we obtain another strategic partner or further commitments from existing partners, we anticipate that future service revenue will be significantly reduced as compared to last fiscal year s service revenue.

We also have longer term initiatives in place to improve our prospects. We expect that development of next generation versions of our AEM products will better position our products in the marketplace and improve our retention rate at hospitals and surgery centers that have changed to AEM technology, enabling us to grow our sales. We are exploring overseas markets to assess opportunities for sales growth internationally. Finally, we intend to explore opportunities to capitalize on our proven AEM technology via licensing arrangements and strategic alliances. These efforts to generate additional sales and further the market penetration of our products are longer term in nature and may not materialize. Even if we are able to successfully develop next generation products or identify potential international markets or strategic partners, we may not be able to capitalize on these opportunities.

Gross Profit and Gross Margins: Gross profit and gross margins can be expected to fluctuate from quarter to quarter as a result of product sales mix, sales volume and development revenue. Gross margins on products manufactured or assembled by us are expected to improve at higher levels of production and sales.

Sales and Marketing Expenses: We continue our efforts to expand domestic and international distribution capability, and we believe that sales and marketing expenses will decrease as a percentage of net sales with increasing sales volume.

Research and Development Expenses: Research and development expenses are expected to increase to support quality improvement efforts and development of refinements to our AEM product line and new products, which will further expand the instrument options for surgeons.

Results of Operations

For the three months ended December 31, 2012 compared to the three months ended December 31, 2011.

Product Revenue. Product revenue for the quarter ended December 31, 2012 was $2,954,849 compared to $2,688,625 for the quarter ended December 31, 2011, an increase of $266,224, an increase of 10%. The increase is attributable to business gained from the addition of 11 new accounts that we opened for

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AEM technology in the three months ended December 31, 2012 versus seven new accounts for AEM technology in the three months ended December 31, 2011.

Service Revenue. Service revenue for the quarter ended December 31, 2012 was $99,831 compared to $478,654 for the quarter ended December 31, 2011, a decrease of $378,823. The decrease is a result of a project that has been phased out by a strategic partner. As a result, and unless we obtain another strategic partner or further commitments from existing partners, we anticipate that future service revenue will be significantly reduced as compared to last fiscal year s service revenue. Service revenue represents design and development services.

G*ross profit*. Product gross profit for the quarter ended December 31, 2012 of $1,637,887 represented an increase of 10% from gross profit of $1,493,207 for the quarter ended December 31, 2011. Gross profit as a percentage of sales (gross margins) decreased from 56% for the quarter ended December 31, 2011 to 55% for the quarter ended December 31, 2012. The decrease in gross margins in the quarter ended December 31, 2012 was the result of increased overhead and scrap costs.

Service gross profit for the quarter ended December 31, 2012 of $28,026 represented a decrease of $219,762 from $247,788 for the quarter ended December 31, 2011. The decrease is a result of a project that has been phased out by a strategic partner.

Sales and marketing expenses. Sales and marketing expenses of $903,068 for the quarter ended December 31, 2012 represented a decrease of 15% from sales and marketing expenses of $1,057,771 for the quarter ended December 31, 2011. The decrease was the result of reduced compensation as a result of reduced direct sales representatives, lower general purchasing organizations fees due to ceasing our relationships with some of our general purchasing organizations, and reduced outside services and travel and meals. The decrease in expense was offset, partially, by increased commission expense for our independent representatives.

General and administrative expenses. General and administrative expenses of $384,926 for the quarter ended December 31, 2012 represented a decrease of 5% from general and administrative expenses of $406,933 for the quarter ended December 31, 2011. The decrease was the result of reduced board of directors fees, and reduced temporary contractor and outside services costs. The decrease in such costs was offset, partially, by increased compensation and bonus accrual.

Research and development expenses. Research and development expenses of $460,765 for the quarter ended December 31, 2012 represented an increase of 36% compared to $338,461 for the quarter ended December 31, 2011. The increase was the result of an increase in compensation and outside services, especially for quality efforts and development of new products, an increase to facilities allocation for additional space, and reduced internal resource cost allocation to service revenue s cost of revenue due to reduced service revenue. The increase in such costs was offset, partially, by decreased temporary help and inventory usage costs.

Net loss. Net loss was $82,482 for the quarter ended December 31, 2012 compared to net loss of $80,557 for the quarter ended December 31, 2011. Net loss was slightly increased as a result of lower service revenue, and the profit thereon. The net loss increase was reduced, partially, from lower operating expenses and reduced interest expense

For the nine months ended December 31, 2012 compared to the nine months ended December 31, 2011.

Product Revenue. Product revenue for the nine months ended December 31, 2012 was $8,566,008 compared to $8,352,200 for the nine months ended December 31, 2011, an increase of 3%. The increase is attributable to business gained by the addition of new accounts and to a reduction of closed accounts. We opened 20 new accounts for AEM technology in the nine months ended December 31, 2012 versus 21 new accounts for AEM technology in the nine months ended December 31, 2011.

Service Revenue. Service revenue for the nine months ended December 31, 2012 was $463,835 compared to $1,266,232 for the nine months ended December 31, 2011, a decrease of $802,397. The decrease is a result of a project that has been phased out by a strategic partner. As a result, and unless we obtain another strategic partner or further commitments from existing partners, we anticipate that future service revenue will be significantly reduced as compared to last fiscal year s service revenue. Service revenue represents design and development services.

G*ross profit*. Product gross profit for the nine months ended December 31, 2012 of $4,874,284 represented an increase of 12% from gross profit of $4,370,862 for the nine months ended December 31, 2011. Gross profit as a percentage of sales (gross margins) increased from 52% for the nine months ended December 31, 2011 to 57% for the nine months ended December 31, 2012. The increase in gross margins in the nine months ended December 31, 2012 was the result of gross margins that were lower in the nine months ended December 31, 2011 due to a one-time charge of $430,000 for a voluntary recall of a certain electrode product and of an increase, principally, in gross margin of our disposable scissor inserts.

Service gross profit for the nine months ended December 31, 2012 of $152,263 represented a decrease of $563,193 from $715,456 for the nine months ended December 31, 2011. The decrease is a result of a project that has been phased out by a strategic partner.

Sales and marketing expenses. Sales and marketing expenses of $2,715,341 for the nine months ended December 31, 2012 represented a decrease of 18% from sales and marketing expenses of $3,308,089 for the nine months ended December 31, 2011. The decrease was the result of lower general purchasing organizations fees due to ceasing our relationships with some of our general purchasing organizations, and reduced outside services and public relations. Further reductions were from reduced compensation as a result of reduced direct sales representatives, and reduced recruiting fees, sales samples, travel and meals.

General and administrative expenses. General and administrative expenses of $1,352,046 for the nine months ended December 31, 2012 represented an increase of 5% from general and administrative expenses of $1,288,629 for the nine months ended December 31, 2011. The increase was the result of outside services, accounting and bank fees, a quality software program and training, and bonus accrual. The increase in such costs was partially offset by reduced compensation expense, principally due to compensation expense for severance cost that was incurred in the nine months ended December 31, 2011, reduced board of directors and investor relations fees, and outside services and temporary contractor costs.

Research and development expenses. Research and development expenses of $1,293,645 for the nine months ended December 31, 2012 represented an increase of 28% compared to $1,011,226 for the nine months ended December 31, 2011. The increase was the result of an increase in compensation and outside services, especially for quality efforts and development of new products, an increase to facilities allocation for additional space, and

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reduced internal resource cost allocation to service revenue cost of revenue due to reduced service revenue. The net increase was reduced, partially, by decreased temporary help and inventory usage costs.

Net loss. Net loss was $336,868 for the nine months ended December 31, 2012 compared to net loss of $570,308 for the nine months ended December 31, 2011. Net loss was reduced, primarily, as a result of a one-time charge of $430,000 in the nine months ended December 31, 2011 and for lower operating expenses and reduced interest expense. The net loss reduction was offset, partially, as a result of reduced service revenue, and the profit thereon.

The results of operations for the three and nine months ended December 31, 2012 are not indicative of the results of operations for all or any part of the balance of the fiscal year.

Liquidity and Capital Resources

At December 31, 2012, operating funds have been provided primarily by issuances of our common stock and warrants and the exercise of stock options to purchase our common stock. Operating funds totaled $21,565,029 from our inception through December 31, 2012.

On May 10, 2012, we signed an amendment to our credit facility agreement with Silicon Valley Bank, effective May 10, 2012. The terms of the credit facility include a line of credit for $2,000,000 for two years at an interest rate calculated at the prime rate plus 1.25%, subject to increase upon a default. Our borrowing under the credit facility is limited by our eligible receivables and inventory at the time of borrowing. The credit facility is secured by all tangible and intangible assets, whether now owned or hereafter acquired, wherever located.

Our operations used $47,228 of cash during the nine months ended December 31, 2012 on net revenue of $8,566,008. Cash was used, principally, by our net loss, increased prepaid expenses and other assets, and decreased accounts payable. Cash used was partially offset by a decrease to accounts receivable, and an increase to accrued compensation and other accrued liabilities. The amounts of cash used by operations for the nine months ended December 31, 2012 are not indicative of the expected amounts of cash to be generated from or used in operations in fiscal year 2013. During the nine months ended December 31, 2012, we invested $253,418 in the acquisition of property and equipment. As of December 31, 2012, we had $472,634 in cash and cash equivalents available to fund future operations. Working capital was $2,771,258 at December 31, 2012 compared to $2,837,788 at March 31, 2012. The decrease to working capital at December 31, 2012 was the result, principally, of our net loss, which was offset, partially, by obtaining net proceeds from the issuance of our common stock. Current liabilities were $1,519,819 at December 31, 2012, compared to $1,672,425 at March 31, 2012. The decrease in current liabilities at December 31, 2012 was caused, principally, by a decrease to accounts payable as a result of obtaining proceeds from the issuance of our common stock.

If we are not successful in maintaining profitability and positive cash flow, additional capital may be required to maintain ongoing operations. We have explored and are continuing to explore options to provide additional financing to fund future operations as well as other possible courses of action. Such actions include, but are not limited to, securing additional lines of credit, sales of debt or equity securities (which may result in dilution to existing shareholders), licensing of technology, strategic alliances and other similar actions. There can be no assurance that we will be able to obtain additional funding (if needed), on acceptable terms or at all, through a sale of our common stock, loans from financial institutions or other third parties, or any of the actions discussed above. If we cannot sustain profitable operations, and additional capital is unavailable, lack of liquidity could have a material adverse effect on our business viability, financial position, results of operations and cash

flows.

We currently lease our facilities at 6797 Winchester Circle, Boulder, Colorado under noncancelable lease agreements through July 31, 2014. The minimum future lease payment by fiscal year as of December 31, 2012 is as follows:

Fiscal Year		**Amount**
2013 (three months remaining)		75,368
2014		320,080
2015		108,303
Total	$	503,751

Our minimum future equipment lease payments with General Electric Capital Corporation as of December 31, 2012, by fiscal year, are as follows:

Fiscal Year		**Amount**
2013 (three months remaining)		25,469
2014		8,488
Total	$	33,957

As of December 31, 2012, the following table shows our contractual obligations for the periods presented:

		Payment due by period			
Contractual obligations	**Totals**	**Less than 1 year**	**1-3 years**	**3-5 years**	**More than 5 years**
Line of credit obligations	$	$	$	$	$
Operating lease obligations	537,708	349,385	188,323		
Total	$ 537,708	$ 349,385	$ 188,323	$	$

Aside from the operating leases and credit facility commitments, we do not have any material contractual commitments requiring settlement i