Recon Technology, Ltd
Form 10-Q
May 15, 2014

U. S. SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 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 March 31, 2014

¨ Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the transition period from _____ to _____.

Commission File Number 001-34409

RECON TECHNOLOGY, LTD

(Exact name of registrant as specified in its charter)

Cayman Islands	**Not Applicable**

(State or other jurisdiction of (I.R.S. employer

incorporation or organization) identification number)

1902 Building C, King Long International Mansion

No. 9 Fulin Road

Beijing 100107 China

(Address of principal executive offices and zip code)

+86 (10) 8494-5799

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x 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.

Large accelerated filer¨ Accelerated filer ¨

Non-accelerated filer ¨ (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 ¨ No x

Indicate the number of shares outstanding of each of the issuer's classes of ordinary shares, as of the latest practicable date. The Company is authorized to issue 25,000,000 ordinary shares. As of the date of this report, the Company has issued and outstanding 4,620,936 shares.

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RECON TECHNOLOGY, LTD

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Special Note Regarding Forward-Looking Statements

This document contains certain statements of a forward-looking nature. Such forward-looking statements, including but not limited to projected growth, trends and strategies, future operating and financial results, financial expectations and current business indicators are based upon current information and expectations and are subject to change based on factors beyond the control of the Company. Forward-looking statements typically are identified by the use of terms such as “look,” “may,” “should,” “might,” “believe,” “plan,” “expect,” “anticipate,” “estimate” and similar words, although so forward-looking statements are expressed differently. The accuracy of such statements may be impacted by a number of business risks and uncertainties that could cause actual results to differ materially from those projected or anticipated, including but not limited to the following:

- the timing of the development of future products;
- projections of revenue, earnings, capital structure and other financial items;
- statements of our plans and objectives;
- statements regarding the capabilities of our business operations;
- statements of expected future economic performance;
- statements regarding competition in our market; and
- assumptions underlying statements regarding us or our business.

Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. The Company undertakes no obligation to update this forward-looking information. Nonetheless, the Company reserves the right to make such updates from time to time by press release, periodic report or other method of public disclosure without the need for specific reference to this report. No such update shall be deemed to indicate that other statements not addressed by such update remain correct or create an obligation to provide any other updates.

Part I Financial Information

Item 1. Financial Statements.

See the unaudited condensed consolidated financial statements following the signature page of this report, which are incorporated herein by reference.

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

The following discussion and analysis of our company's financial condition and results of operations should be read in conjunction with our unaudited condensed consolidated financial statements and the related notes included elsewhere in this report. This discussion contains forward-looking statements that involve risks and uncertainties. Actual results and the timing of selected events could differ materially from those anticipated in these forward-looking statements as a result of various factors.

Overview

We are a company with limited liability incorporated in 2007 under the laws of the Cayman Islands. Headquartered in Beijing, we provide products and services to oil and gas companies and their affiliates through our Domestic Companies. As the company contractually controlling the Domestic Companies, we are the center of strategic management, financial control and human resources allocation.

Our business is mainly focused on the upstream sectors of the oil and gas industry. We derive our revenues from the sales and provision of (1) hardware products, (2) software products, and (3) services. Our products and services involve most of the key procedures of the extraction and production of oil and gas, and include automation systems, equipment, tools and on-site technical services.

Our VIEs provide the oil and gas industry with equipment, production technologies, automation and services.

- Nanjing Recon: Nanjing Recon is a high-tech company that specializes in automation services for oilfield companies. It mainly focuses on providing automation solutions to the oil exploration industry, including monitoring wells, automatic metering to the joint station production, process monitor, and a variety of oilfield equipment and control

systems.

- BHD: BHD is a high-tech company that specializes in transportation equipment and stimulation productions and services. Possessing proprietary patents and substantial industry experience, BHD has built up stable and strong working relationships with the major oilfields in China.

Products and Services

We provide the following three types of integrated products and services for our customers.

Equipment for Oil and Gas Production and Transportation

High-Efficiency Heating Furnaces. Crude petroleum contains certain impurities that must be removed before it can be sold, including water and natural gas. To remove the impurities and to prevent solidification and blockage in transport pipes, companies employ heating furnaces. BHD researched, developed and implemented a new oilfield furnace that is advanced, highly automated, reliable, easily operable, safe and highly heat-efficient (90% efficiency).

Burner. We serve as an agent for the Unigas Burner, which is designed and manufactured by UNIGAS, a European burning equipment production company. The burner we provide has the following characteristics: high degree of automation, energy conservation, high turn-down ratio, high security and environmental safety.

Oil and Gas Production Improvement Techniques

Packers of Fracturing. This utility model is used in concert with the security joint, hydraulic anchor, and slide brushing of sand spray in the well. It is used for easy seat sealing and sand uptake prevention. The utility model reduces desilting volume and prevents sand-up, which makes the deblocking processes easier to realize. The back flushing is sand-stick proof.

Production Packer. At varying withdrawal points, the production packer separates different oil layers and protects the oil pipe from sand and permeation, promoting the recovery ratio.

Sand Prevention in Oil and Water Well. This technique processes additives that are resistant to elevated temperatures into “resin sand” which is transported to the bottom of the well via carrying fluid. The “resin sand” goes through the borehole, pilling up and compacting at the borehole and oil vacancy layer. An artificial borehole wall is then formed, functioning as a means of sand prevention. This sand prevention technique has been adapted to more than 100 wells, including heavy oil wells, light oil wells, water wells and gas wells, with a 100% success rate and a 98% effective rate.

Water Locating and Plugging Technique. High water cut affects the normal production of oilfields. Previously, there was no sophisticated method for water locating and tubular column plugging in China. The mechanical water locating and tubular column plugging technique we have developed resolves the problem of high water cut wells. This technique conducts a self-sealing test during multi-stage usage and is reliable to separate different production sets effectively. The water location switch forms a complete set by which the water locating and plugging can be finished in one trip. The tubular column is adaptable to several oil drilling methods and is available for water locating and plugging in second and third class layers.

Fissure Shaper. This is our proprietary product that is used along with a perforating gun to effectively increase perforation depth by between 46% and 80%, shape stratum fissures, improve stratum diversion capability and, as a result, improve our ability to locate oilfields and increase the output of oil wells.

Fracture Acidizing. We inject acid to layers under pressure, which can form or expand fissures. The treatment process of the acid is defined as fracture acidizing. The technique is mainly adapted to oil and gas wells that are blocked up relatively deeply, or the ones in low permeability zones.

Electronic Break-Down Service. This service resolves block-up and freezing problems by generating heat from the electric resistivity of the drive pipe and utilizing a loop tank composed of an oil pipe and a drive pipe. This technique saves energy and is environmentally friendly. It can increase the production of oilfields that are in the middle and later periods.

Automation System and Services

Pumping Unit Controller. This controller functions as a monitor to the pumping unit and also collects data for load, pressure, voltage, and startup and shutdown control.

RTU Monitor. This monitor collects gas well pressure data.

Wireless Dynamometer and Wireless Pressure Gauge. These products replace wired technology with cordless displacement sensor technology. They are easy to install and significantly reduce the work load associated with cable laying.

Electric Multi-way Valve for Oilfield Metering Station Flow Control. This multi-way valve is used before the test separator to replace the existing three valve manifolds. It facilitates the electronic control of the connection of the oil lead pipeline with the separator.

Natural Gas Flow Computer System. The flow computer system is used in natural gas stations and gas distribution stations to measure flow.

Recon Supervisory Control and Data Acquisition System ("SCADA"). Recon SCADA is a system which applies to the oil well, measurement station, and the union station for supervision and data collection.

EPC Service of Pipeline SCADA System. This service technique is used for pipeline monitoring and data acquisition after crude oil transmission.

EPC Service of Oil and Gas Wells SCADA System. This service technique is used for monitoring and data acquisition of oil wells and natural gas wells.

EPC Service of Oilfield Video Surveillance and Control System. This video surveillance technique is used for controlling the oil and gas wellhead area and the measurement station area.

Technique Service for "Digital oilfield" Transformation. This service includes engineering technique services such as oil and gas SCADA system, video surveillance and control system and communication systems.

Factors Affecting Our Business

Business Outlook

The oilfield engineering and technical service industry is generally divided into five sections: (1) exploration, (2) drilling and completion, (3) testing and logging, (4) production, and (5) oilfield construction. Thus far our businesses have been involved in completion, production and construction processes. Our management still believes we need to expand our core business, move into new markets, and develop new businesses quickly for the coming years. Management anticipates great opportunities both in new markets and our existing markets. We believe that many existing wells and oilfields need to improve or renew their equipment and service to maintain production and techniques and services like ours will be needed as new oil and gas fields are developed. In the next three years, we will focus on:

Measuring Equipment and Service. "Digital oil field" and the management of oil companies are highly regarded. We believe our oilfield SCADA and related technical support services will address the needs of the oil well automation system market, for which we forecast strong needs in the short term. In addition, through early cooperation with CNPC in Turkmenistan, we have developed our experience in this market. Although bidding has not yet commenced ,

we will continue pursuing overseas business projects in the coming second phase construction, which we expect to occur in 2014.

***Gathering and Transferring Equipment*.** With more new wells developed, our management anticipates that demand for our furnaces and burners will grow more compared to last year, especially in the Jilin Oilfield and Zhongyuan oilfield.

***Fracturing service*.** We believe we cooperated well with Zhongyuan Oilfield in fiscal year 2013 and expect to continue growing revenue from fracturing and related stimulation services for fiscal year 2014, from Zhongyuan oilfield and also some other oilfields clients.

***New product line*.** Design and development of down-hole tools has always been an important technique for oilfield companies. Recently, this market has developed very rapidly. After a year test project for our customers, we have developed experience with this technology and our customers have accepted our products and services. We expect revenue from this business in fiscal year 2014.

Growth Strategy

As a smaller China-focused company, it is our basic strategy to focus on developing our onshore oilfield business, that is, the upstream of the industry. Due to the remote location and difficult environments of China's oil and gas fields, foreign competitors rarely enter those areas.

Large domestic oil companies have historically focused on their exploration and development businesses to earn higher margins and keep their competitive advantage. With regard to private oilfield service companies, we estimate that approximately 90% specialize in the manufacture of drilling and production equipment. Thus, the market for technical support and project service is still in its early stage. Our management insists on providing high quality products and service in oilfields in which we have a geographical advantage. This will allow us to avoid conflicts of interest with bigger suppliers of drilling equipment and protect our position within the market segment. Our mission is to increase the automation and safety levels of industrial petroleum production in China and improve the underdeveloped working process and management mode by using advanced technologies. At the same time, we are always looking to improve our business and to increase our earning capability.

Industry and Recent Developments

Despite uncertainty in the energy industry related to such matters as fluctuating prices and future opportunities for oil companies, our management believes there are still many factors to support our long-term development:

The opening of the Chinese oil industry to participation by non-state owned service providers and vendors played an increasingly important role in the high-end oilfield service segment to allow competition based on efficiency and price. As oil and gas fields are depleted, it becomes more challenging to find and convert reserves into usable energy sources. As the industry has permitted competition by private companies and oil companies have formed separate service companies, high-tech service has gradually opened up to private companies.

Overseas assets of Chinese oilfield companies increased gradually, and they will provide more opportunity for domestic service companies to participate in foreign projects.

Management is focused on these factors and will seek to extend our business on the industrial chain, like providing more integrated services and incremental measures and growing our business from a predominantly up-ground business to include some down-hole services as well.

Factors Affecting Our Results of Operations

Our operating results in any period are subject to general conditions typically affecting the Chinese oilfield service industry including:

- the amount of spending by our customers, primarily those in the oil and gas industry;
- growing demand from large corporations for improved management and software designed to achieve such corporate performance;
- the procurement processes of our customers, especially those in the oil and gas industry;
- competition and related pricing pressure from other oilfield service solution providers, especially those targeting the Chinese oil and gas industry;
- the ongoing development of the oilfield service market in China; and
- inflation and other macroeconomic factors.

Unfavorable changes in any of these general conditions could negatively affect the number and size of the projects we undertake, the number of products we sell, the amount of services we provide, the price of our products and services, and otherwise affect our results of operations.

Our operating results in any period are more directly affected by company-specific factors including:

- our revenue growth, in terms of the proportion of our business dedicated to large companies and our ability to successfully develop, introduce and market new solutions and services;
- our ability to increase our revenues from both old and new customers in the oil and gas industry in China;
- our ability to effectively manage our operating costs and expenses; and
- our ability to effectively implement any targeted acquisitions and/or strategic alliances so as to provide efficient access to markets and industries in the oil and gas industry in China.

Critical Accounting Policies and Estimates

Estimates and Assumptions

We prepare our unaudited condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States of America (U.S. GAAP), which require us to make judgments, estimates and assumptions. We continually evaluate these estimates and assumptions based on the most recently available information, our own historical experience and various other assumptions that we believe to be reasonable under the circumstances. Since the use of estimates is an integral component of the financial reporting process, actual results could differ from those estimates. An accounting policy is considered critical if it requires an accounting estimate to be made based on assumptions about matters that are highly uncertain at the time such estimate is made, and if different accounting estimates that reasonably could have been used, or changes in the accounting estimates that are reasonably likely to occur periodically, could materially impact the consolidated financial statements. We believe that the following policies involve a higher degree of judgment and complexity in their application and require us to make significant accounting estimates. The following descriptions of critical accounting policies, judgments and estimates should be read in conjunction with our consolidated financial statements and other disclosures included in this quarterly report. Significant accounting estimates reflected in our Company's consolidated financial statements include revenue recognition, allowance for doubtful accounts, and useful lives of property and equipment.

Consolidation of VIEs

We recognize an entity as a VIE if it either (i) has insufficient equity to permit the entity to finance its activities without additional subordinated financial support or (ii) has equity investors who lack the characteristics of a controlling financial interest. We consolidate a VIE as its primary beneficiary when we have both the power to direct the activities that most significantly impact the entity's economic performance and the obligation to absorb losses or the right to receive benefits from the entity that could potentially be significant to the VIE. We perform ongoing assessments to determine whether an entity should be considered a VIE and whether an entity previous identified as a VIE continues to be a VIE and whether we continue to be the primary beneficiary.

Assets recognized as a result of consolidating VIEs do not represent additional assets that could be used to satisfy claims against our general assets. Conversely, liabilities recognized as a result of consolidating these VIEs do not represent additional claims on our general assets; rather, they represent claims against the specific assets of the consolidated VIEs.

Revenue Recognition

We recognize revenue when the following four criteria are met: (1) persuasive evidence of an arrangement exists, (2) delivery has occurred or services have been provided, (3) the sales price is fixed or determinable, and (4) collectability is reasonably assured. Delivery does not occur until products have been shipped or services have been provided to the customers and the customers have signed a completion and acceptance report, risk of loss has transferred to the customers, customer- acceptance-provisions have lapsed, or the Company has objective evidence that the criteria specified in customers' acceptance provisions have been satisfied. The sales price is not considered to be fixed or determinable until all contingencies related to the sale have been resolved.

Hardware

Revenue from hardware sales is generally recognized when the product is shipped to the customer and when there are no unfulfilled company obligations that affect the customer's final acceptance of the arrangement.

Services

The Company provides services to improve software functions and system requirements on separated fixed-price contracts. Revenue is recognized when services are completed and acceptance is determined by a completion report signed by the customer.

Deferred income represents unearned amounts billed to customers related to sales contracts.

Fair Values of Financial Instruments

The US GAAP accounting standards regarding fair value of financial instruments and related fair value measurements define fair value, establish a three-level valuation hierarchy that requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

The three levels of inputs are defined as follows:

Level 1 inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2 inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

Level 3 inputs to the valuation methodology are unobservable.

The carrying amounts reported in the consolidated balance sheets for trade accounts receivable, other receivables, advances to suppliers, trade accounts payable, accrued liabilities, advances from customers and notes payable approximate fair value because of the immediate or short-term maturity of these financial instruments. Long-term receivables and borrowings approximate fair value because their interest rates charged approximate the market rates for financial instruments with similar terms. The fair value of the warrants liability was determined using the Black-Scholes Model, as Level 2 inputs (See Note 13). Any changes in the assumptions that are used in the Black-Scholes Model may increase or decrease the warrants liability from quarter to quarter. Any change in adjustment would be charged to operations.

Receivables

Trade receivables are carried at original invoiced amount less a provision for any potential uncollectible amounts. Provisions are applied to trade receivables where events or changes in circumstances indicate that the balance may not be collectible. The identification of doubtful accounts requires the use of judgment and estimates of management. Our management must make estimates of the collectability of our accounts receivable. Management specifically analyzes accounts receivable, historical bad debts, customer creditworthiness, current economic trends and changes in our customer payment terms when evaluating the adequacy of the allowance for doubtful accounts. We believe based on the current economic condition and our history of collections on accounts and notes receivable, our allowance for doubtful accounts was adequate at March 31, 2014.

Valuation of Long-Lived Assets

We review the carrying values of our long-lived assets for impairment whenever events or changes in circumstances indicate that they may not be recoverable. When such an event occurs, we project undiscounted cash flows to be generated from the use of the asset and its eventual disposition over the remaining life of the asset. If projections indicate that the carrying value of the long-lived asset will not be recovered, we reduce the carrying value of the long-lived asset by the estimated excess of the carrying value over the projected discounted cash flows. In the past, we have not had to make significant adjustments to the carrying values of our long-lived assets, and we do not anticipate a need to do so in the future. However, circumstances could cause us to have to reduce the value of our capitalized assets more rapidly than we have in the past if our revenues were to significantly decline. Estimated cash flows from the use of the long-lived assets are highly uncertain and therefore the estimation of the need to impair these assets is reasonably likely to change in the future. Should the economy or acceptance of our assets change in the future, it is likely that our estimate of the future cash flows from the use of these assets will change by a material amount. There were no impairments at June 30, 2013 and March 31, 2014.

Share-Based Compensation

The Company accounts for share-based compensation in accordance with ASC Topic 718, Share-Based Payment. Under the fair value recognition provisions of this topic, share-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as expense with graded vesting on a straight–line basis over the requisite service period for the entire award. The Company has elected to recognize compensation expenses mainly using the Black-Scholes valuation model estimated at the grant date based on the award's fair value.

Results of Operations

Three Months Ended March 31, 2014 Compared to Three Months Ended March 31, 2013

Revenues

	For the Three Months Ended March 31,			
	2013	2014	Increase / (Decrease)	Percentage Change
Hardware -non-related parties	¥4,161,583	¥17,763,602	¥13,602,019	326.8 %
Hardware - related parties	1,028,606	94,446	(934,160)	(90.8)%
Service	62,678	80,180	17,502	27.9 %
Software-non-related parties	-	234,842	234,842	100 %
Software - related parties	2,248,928	59,400	(2,189,528)	(97.4)%
Total revenues	¥7,501,795	¥18,232,470	¥10,730,675	143.0 %

Revenues. Our revenues increased by 143%, or approximately ¥10.7 million ($1.7 million), from approximately ¥7.5 million for the three months ended March 31, 2013 to ¥18.2 million ($3 million) for the same period of 2014. The changes in our revenues for the three-month period were due to the following factors:

(1) Hardware business. During the three-month ended March 31, 2014, the increase in hardware revenue was mainly caused by higher sales of automation business from the Southwest branch of Sinopec and sales of furnaces to the Jilin Oilfield.

(2) Hardware – related parties. Sales of hardware to related parties decreased due to the reclassification of revenue from related party hardware revenue to non-related party hardware revenue. After we achieved business entrance certification in the name of Recon and could cooperate with oilfield customers directly two years ago, we no longer required the services of a related party with such certification and, accordingly, revenue from related-parties decreased. So long as the local agency still purchases automation products from Recon, we will continue to recognize revenue from related parties, but we anticipate that such hardware and software related party revenue is likely to fluctuate from year to year.

(3) Service business. Service revenue for three months ended March 31, 2013 and 2014 consisted mainly of minor maintenance services, which were provided upon request by customers.

(4) Software business. The software sales to non-related parties increased approximately ¥0.2 million ($38,000). We record revenue as software sales if (1) the customer signs a separate software contract with us, or (2) the customer accepts VAT invoices for software. The amount of our revenues categorized as software sales may fluctuate because certain software may be sold with hardware at times as a whole product and not separately priced.

(5) Software business – related parties. During the quarter ended March 31, 2014, we recorded software revenue of ¥59,400 ($9,640) to a related party. As mentioned above, we used to develop our Ji Dong oilfield business through a local agent that is a related party. Since we achieved business entrance certification by ourselves and could thus directly compete for projects, revenue through this related party decreased overall. So Software revenue from related party also decreased during this period.

Cost and Margin

	For the Three Months Ended March 31,			
	2013	2014	Increase / (Decrease)	Percentage Change
Total revenues	¥7,501,795	¥18,232,470	¥10,730,675	143.0 %
Cost of revenues	3,346,344	12,987,514	9,641,170	288.1 %
Gross profit	¥4,155,451	¥5,244,956	¥1,089,505	26.2 %
Margin %	55.4 %	28.8 %	(26.6)%	__

Cost of revenues. Our cost of revenues includes raw materials and costs related to design, implementation, delivery and maintenance of products and services. All materials and components we need can be purchased or manufactured by subcontracts. Usually the prices of electronic components do not fluctuate dramatically due to market competition and will not significantly affect our cost of revenues. However, specialized equipment and incentive chemical products may be directly influenced by metal and oil price fluctuations. Additionally, the prices of some imported accessories mandated by our customers can also impact our cost.

Our cost of revenues increased from approximately ¥3.3 million in the three months ended March 31, 2013 to approximately ¥13.0 million ($2.1 million) for the same period of 2014, an increase of approximately ¥9.6 million ($1.6 million), or 288.1%. This increase was mainly caused by higher revenue during the three months ended March 31, 2014 compared to the same period of 2013. As a percentage of revenues, our cost of revenues increased from 44.6% in 2013 to 71.2% in 2014, largely due to increased hardware sales, which feature higher cost of revenues, than service or software revenues.

Gross profit. Our gross profit increased to approximately ¥5.2 million ($0.9 million) for the three months ended March 31, 2014 from approximately ¥4.2 million for the same period in 2013. Our gross profit as a percentage of revenue decreased to 28.8% for the three months ended March 31, 2014 from 55.4% for the same period in 2013. This was mainly due to increased hardware revenue with lower gross profit margins during the three months ended March 31, 2014 as compared to the same period last year where we had higher software revenue with higher gross margins during the three months ended March 31, 2013.

In more detail:

	For the Three Months Ended March 31,			
	2013	2014	Increase / (Decrease)	Percentage Change
Total revenues-hardware and software- non related parties	¥4,161,583	¥17,998,444	¥13,836,861	332.5 %
Cost of revenues -hardware and software- non related parties	2,527,534	12,848,136	10,320,602	408.3 %
Gross profit	¥1,634,049	¥5,150,308	¥3,516,259	215.2 %
Margin %	39.3 %	28.6 %	(10.7)%	__

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The revenue increase from hardware and software to non-related parties of ¥13.8 million was mainly due to the increase from the furnaces sales and automation business in the three months ended March 31, 2014. The gross profit from the hardware and software sales to non-related parties increased ¥ 3.5 million ($0.6 million) compared to the same period of last year.

	For the Three Months Ended March 31,			
	2013	2014	Increase / (Decrease)	Percentage Change
Total revenues-hardware and software- related parties	¥3,277,534	¥153,846	¥(3,123,688)	(95.3)%
Cost of revenues -hardware and software - related parties	798,190	97,217	(700,973)	(87.8)%
Gross profit	¥2,479,344	¥56,629	¥(2,422,715)	(97.7)%
Margin %	75.6%	36.8%	(38.8)%	__

Cost of revenue from hardware and software-related parties decreased as revenue decreased. While gross profit decreased was mainly because revenue decreased as we developed business directly with oilfield, rather than cooperation with some parties.

For the Three Months Ended March 31,	
	Increase /