

Recon Technology, Ltd  
Form 10-Q  
February 16, 2016

U. S. SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q

Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended December 31, 2015

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  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).    Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company.

Large accelerated filer

Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company)    Smaller reporting company

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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 ordinary shares, as of the latest practicable date. The Company is authorized to issue 100,000,000 ordinary shares. As of February 16, 2016, the Company has issued and outstanding 5,804,005 shares.

**RECON TECHNOLOGY, LTD**

**FORM 10-Q**

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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 some forward-looking statements are expressed differently. The accuracy of such statements may be influenced 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 of this report. 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 certain 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 Nanjing Recon Technology Co. Ltd ("Nanjing Recon") and Beijing BHD Petroleum Technology Co, Ltd ("BHD"), hereafter referred to as our domestic companies (the "Domestic Companies"), which are established as variable interest entities ("VIEs") under the laws of the People's Republic of China ("PRC"). As the Company contractually controls the Domestic Companies, we are the center of strategic management, financial control and human resources allocation.

Through Nanjing Recon and BHD, 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 Domestic Companies 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.

### ***Recent Developments***

On September 22, 2015, the Company entered into an amendment to the Company's letter agreement (the "Agreement") with Maxim Group LLC, dated January 28, 2015, pursuant to which Maxim would serve as the Company's exclusive agent in connection with a proposed at-the-market offering program by the Company of up to \$10,000,000. The amendment extends the term of the Agreement for an additional six months, or until February 29, 2016. As of February 16, 2016, no shares have been issued under the amended Agreement.

On December 1, 2015, the Company entered into a share purchase agreement to acquire a 100% interest in Qinghai Huayou Downhole Technologies Co., Ltd. ("QHXY"), a PRC corporation and oilfield service provider in Qinghai province. This transaction is subject to shareholders approval.

### *Products and Services*

We currently provide products and services to oil and gas field companies focused on the development and production of oil and natural gas. Our products and services described below correlate to the numbered stages of the oilfield production system graphical expression shown below.

Our products and services include:

#### *Equipment for Oil and Gas Production and Transportation*

High-Efficiency Heating Furnaces (*as shown above*). 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, easy to operate, safe and highly heat-efficient (90% efficiency).

Burner (*as shown above*). 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, piling 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 oil and gas wells 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 systems, video surveillance and control systems 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 the 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 there will be opportunities in new markets and our existing markets. We also 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 plan to focus on:

***Measuring Equipment and Service.*** Digital oil field technology and the management of oil companies are highly regarded in the industry. We believe our oilfield SCADA and related technical support services will address the needs of the oil well automation system market, for which we believe there will be increasing demand over the short term and strong needs in the long term.

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

***Fracturing service.*** We expect demand for fracturing will increase in China and we are focused on the development and upgrade of current down-hole tools which can be used in this sector.

***New business.*** We are in the process of expanding our business through the acquisition of a down-hole service company. We also have developed new products for oilfield wastewater treatment and achieved preliminary business on this segment. Our management anticipates expanding the new business more rapidly in the coming year.

### ***Growth Strategy***

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

historically foreign competitors have rarely entered those areas directly.

Large domestic oil companies have historically focused on their exploration and development businesses to earn higher margins and maintain 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 is focused on providing high quality products and service in oilfields in which we have a geographical advantage. This helps us to avoid conflicts of interest with bigger suppliers of drilling equipment while protecting our position within this 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 used by many companies by providing advanced technologies. At the same time, we are always looking to improve our business and to increase our earning capability.

### *Recent Industry Developments*

Despite uncertainty in the energy sector 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:

(1) The opening of the Chinese oil industry to participation by non-state owned service providers and vendors has 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.

(2) As worldwide oil and gas prices decreased, development transformed and strict management has been a frequent subject of domestic oil companies. Technology reforms have been their first choice to achieve their goals about quality and efficiency upgrades. Furthermore, the construction of digital oilfields is a long-term development strategy for many domestic oil companies. Even though total capital expenditure is expected to be reduced, we believe investment in technology reform will remain at a high level. We believe the Company will benefit from this trend.

Management is focused on these factors and will seek to extend our business on the industrial chain, such as through providing more integrated services, 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:

- Oil and gas price;
- 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 (“US 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, inventory valuation, warrants liability, fair value of share based payments, 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 our 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 previously 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 customer, customer acceptance provisions have lapsed, or the Company has objective evidence that the criteria specified in a customer's 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.

### *Software*



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The Company sells self-developed software. For software sales, the Company recognizes revenues in accordance with the provisions of Accounting Standards Codification, Topic 985-605, "Software Revenue Recognition," and related interpretations. Revenue from software is recognized according to project contracts. Contract costs are accumulated during the periods of installation and testing or commissioning. Usually this is short term. Revenue is not recognized until completion of the contracts and receipt of acceptance statements.

### *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.

### ***Cost of Revenues***

When the criteria for revenue recognition have been met, costs incurred are recognized as cost of revenue. Cost of revenues includes wages, materials, handling charges, the cost of purchased equipment and pipes, other expenses associated with manufactured products and services provided to customers, and inventory reserve. We expect cost of revenues to grow as our revenues grow. It is possible that we could incur development costs with little revenue recognition, but based upon our past history, we expect our revenues to grow.

### ***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 the

estimate of the fair value of the warrants liability would be charged to operations.

### ***Receivables***

Trade receivables are carried at the 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. Increases in our allowance for doubtful accounts would lower our net income and earnings per share.

### ***Deferred Tax Estimates***

As part of the process of preparing our consolidated financial statements, we are required to estimate our income taxes in each of the tax jurisdictions in which we operate. This process involves using an asset and liability approach whereby deferred tax assets and liabilities are recorded for differences in the financial reporting bases and tax bases of our assets and liabilities. Deferred tax accounting requires that we evaluate net deferred tax assets by jurisdiction to determine if these assets will more likely than not be realized. This analysis requires considerable judgment and is subject to change to reflect future events and changes in the tax laws. If an allowance is established against our deferred tax assets because they may not be fully realizable in the future, our net income and earnings per share would decrease.

### ***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, 2015 and December 31, 2015. However, if impairment were required, our net income and earnings per share would decrease accordingly.

### ***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 mainly utilize the Black-Scholes valuation model to estimate an award's fair value.

### ***Recently enacted accounting pronouncements***

In August 2015, the FASB issued Accounting Standards Update (ASU) No. 2015-15, Interest - Imputation of Interest (Subtopic 835-30): Presentation and Subsequent Measurement of Debt Issuance Costs Associated with Line-of-Credit Arrangements - Amendments to SEC Paragraphs Pursuant to Staff Announcement at the June 18, 2015 EITF Meeting. This ASU adds additional paragraphs pursuant to the SEC Staff Announcement at the June 18, 2015 Emerging Issues Task Force meeting about the presentation and subsequent measurement of debt issuance costs associated with line-of-credit arrangements. Given the absence of authoritative guidance within ASU 2015-03 for debt issuance costs related to line-of-credit arrangements, the SEC staff would not object to an entity deferring and presenting debt issuance costs as an asset and subsequently amortizing the deferred debt issuance costs ratably over the term of the line-of-credit arrangement, regardless of whether there are any outstanding borrowings on the line-of-credit arrangement. The Company does not expect this update will have a material impact on the presentation of the Company's condensed consolidated financial statements.

In September 2015, the FASB issued ASU 2015-16, Business Combinations (Topic 805): Simplifying the Accounting for Measurement-Period Adjustments, which eliminates the requirement to retrospectively account for changes to provisional amounts initially recorded in a business acquisition opening balance sheet. Prior to the issuance of ASU 2015-16, an acquirer was required to restate prior period financial statements as of the acquisition date for adjustments to provisional amounts. This guidance is effective for fiscal years beginning after December 15, 2015, including interim periods within fiscal years. The Company does not expect this update will have a material impact on the presentation of the Company's condensed consolidated financial statements.

In November 2015, the FASB issued Accounting Standards Update (ASU) No. 2015-17, Income Taxes (Topic 740): Balance Sheet Classification of Deferred Taxes, which changes how deferred taxes are classified on organizations' balance sheets. The ASU eliminates the current requirement for organizations to present deferred tax liabilities and assets as current and noncurrent in a classified balance sheet. Instead, organizations will be required to classify all deferred tax assets and liabilities as noncurrent. The amendments apply to all organizations that present a classified balance sheet. For public companies, the amendments are effective for financial statements issued for annual periods beginning after December 15, 2016, and interim periods within those annual periods. The Company does not expect this update will have a material impact on the presentation of the Company's consolidated financial position, results of operations and cash flows.

In January 2016, the FASB issued Accounting Standards Update (ASU) No. 2016-01, Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. The new guidance makes targeted improvements to existing U.S. GAAP by: (1) requiring equity investments to be measured at fair value with changes in fair value recognized in net income; (2) requiring separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements; (3) eliminating the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet; and (4) requiring a reporting organization to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk. The new guidance is effective for public companies for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company does not expect this update will have a material impact on the presentation of the Company's consolidated financial position, results of operations and cash flows.

## Results of Operations

The following consolidated results of operations include the results of operations of the Company and its variable interest entities (“VIEs”), BHD and Nanjing Recon.

Our historical reporting results are not necessarily indicative of the results to be expected for any future period.

### *Three Months Ended December 31, 2015 Compared to Three Months Ended December 31, 2014*

#### *Revenues*

	For the Three Months Ended December 31,		Increase/ (Decrease)	Percentage Change	
	2014	2015			%
Hardware - non-related parties	¥19,689,503	¥27,857,380	¥8,167,877	41.5	%
Hardware - related parties	524,528	-	(524,528 )	(100.0 )	)
Service	45,283	985,050	939,767	2,075.3	%
Software - non-related parties	826,068	-	(826,068 )	(100.0 )	)%
Software - related parties	243,590	-	(243,590 )	(100.0 )	)%
Total revenues	¥21,328,972	¥28,842,430	¥7,513,458	35.2	%

Our total revenues for the three months ended December 31, 2015 were approximately ¥28.8 million (\$4.4 million), an increase of approximately ¥7.5 million or 35.2% from ¥21.3 million for the three months ended December 31, 2014. This was mainly caused by an increase of sales of automation products.

#### *Cost and Margin*

	For the Three Months Ended December 31,		Increase / (Decrease)	Percentage Change	
	2014	2015			%
Total revenues	¥21,328,972	¥28,842,430	¥7,513,458	35.2	%

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Cost of revenues	12,351,041	23,079,751	10,728,710	86.9	%
Gross profit	¥8,977,931	¥5,762,679	¥(3,215,252 )	(35.8	)%
Margin %	42.1	% 20.0	% (22.1	)%	—

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. Inventory reserve for changes in price level, impairment of inventory, slow moving or other causes will also affect our cost..



Our cost of revenues increased from approximately ¥12.3 million in the three months ended December 31, 2014 to approximately ¥23.1 million (\$3.6 million) for the same period in 2015, an increase of approximately ¥10.7 million (\$1.65 million), or 86.9%. This increase was mainly caused by higher revenue during the three months ended December 31, 2015 compared to the same period of 2014. As a percentage of revenues, our cost of revenues increased from 57.9% in 2014 to 80.0% in 2015, due to the increase of sale of hardware products, the cost of which is higher than the software and service revenues and the increase in the cost of goods sold.

Gross profit. Our gross profit decreased to approximately ¥5.8 million (\$0.9 million) for the three months ended December 31, 2015 from approximately ¥9.0 million for the same period in 2014. Our gross profit as a percentage of revenue decreased to 20.0% for the three months ended December 31, 2015 from 42.1% for the same period in 2014. This was mainly due to the decrease of software sales with higher margins compared with the hardware revenues.

Our software and hardware revenues are detailed as below:

	For the Three Months Ended December 31,		Increase/ (Decrease)	Percentage Change	
	2014	2015			
Total revenues-hardware and software- non related parties	¥20,515,571	¥27,857,380	¥7,341,809	35.8	%
Cost of revenues -hardware and software- non related parties	12,334,279	22,402,781	10,068,502	81.6	%
Gross profit	¥8,181,292	¥5,454,599	¥(2,726,693 )	(33.3	)%
Margin %	39.9	% 19.6	% (20.3	)%	-

Revenue from hardware and software to non-related parties increased by approximately ¥7.3 million mainly due to the increase of hardware products sold in the three months ended December 31, 2015. The gross profit from hardware and software sales to non-related parties decreased ¥2.7 million (\$0.4 million) compared to the same period of last year.

	For the Three Months Ended December 31,		Increase/ (Decrease)	Percentage Change	
	2014	2015			
Total revenues-hardware and software-related parties	¥768,118	¥ -	¥(768,118 )	(100	)%
Cost of revenues -hardware and software- related parties	16,762	-	(16,762 )	(100	)%
Gross profit	¥751,356	¥ -	¥(751,356 )	(100	)%
Margin %	97.8	% -	(97.8	%)	-



Revenue from related parties decreased as we developed business directly with oilfield, rather than cooperation with some local agency, which used to be our related parties.

	For the Three Months Ended December 31,			
	2014	2015	Increase / (Decrease)	Percentage Change
Total revenues-service	¥45,283	¥985,050	¥939,767	2,075.3 %
Cost of reven				