

FONAR CORP  
Form 10-K  
September 29, 2014

SECURITIES AND EXCHANGE COMMISSION WASHINGTON, D.C. 20549

**FORM 10-K**

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 [Fee Required]

For the fiscal year ended June 30, 2014

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES AND EXCHANGE ACT OF 1934 [No Fee Required]

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File No. 0-10248

\_\_\_\_\_

**FONAR CORPORATION**

(Exact name of registrant as specified in its charter)

DELAWARE      11-2464137  
(State of      (IRS  
incorporation)      Employer  
                         Identification  
                         Number)

110 Marcus  
Drive, Melville,      11747  
New York  
(Address of  
principal  
executive      (Zip Code)  
offices)

(631) 694-2929  
(Registrant's  
telephone number,

including area  
code)

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Securities registered pursuant to Section 12(b) of the Act:

Common Stock, par value \$.0001 per share

Securities registered pursuant to Section 12(g) of the Act:

None

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Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.  
Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

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 (1) 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 (Section 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 if disclosure of delinquent filers, pursuant to Item 405 of Regulation S-K, §229.405 of this Chapter, is not contained, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this 10-K or any amendment to the Form 10-K. [X]

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

FONAR CORPORATION AND SUBSIDIARIES

(Check one): Large accelerated filer , Accelerated filer , Non-accelerated filer (Do not check if a smaller reporting company) . Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

The aggregate market value of the shares of Common Stock held by non-affiliates as of December 31, 2013 based on the closing price of \$21.21 per share on such date as reported on the NASDAQ System, was approximately \$125 million. The other outstanding classes do not have a readily determinable market value.

As of September 5, 2014, 6,050,840 shares of Common Stock, 146 shares of Class B Common Stock, 382,513 shares of Class C Common Stock and 313,438 shares of Class A Non-voting Preferred Stock of the registrant were outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

None

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## FONAR CORPORATION AND SUBSIDIARIES

### PART I

#### ITEM 1. BUSINESS

##### GENERAL

Fonar Corporation, sometimes referred to as the "Company" or "Fonar", is a Delaware corporation which was incorporated on July 17, 1978. Our address is 110 Marcus Drive, Melville, New York 11747 and our telephone number is 631-694-2929. Fonar also maintains a website at [www.fonar.com](http://www.fonar.com). Fonar provides copies of its filings with the Securities and Exchange Commission on Forms 10-K, 10-Q and 8-K and amendments to these reports to stockholders on request.

We conduct our business in two segments. Our medical equipment segment is conducted directly through Fonar. Our physician management and diagnostic services segment is conducted through our subsidiary Health Management Corporation of America ("HMCA"). HMCA performs services through two subsidiaries. In fiscal 2011, HMCA assigned its assets and liabilities to a limited liability company, Imperial Management Services, LLC ("Imperial") for a controlling interest in Imperial. In addition to Imperial, in fiscal 2013, HMCA purchased a 50.5% interest in another limited liability company, Health Diagnostic Management, LLC ("HDM"), which, with some exceptions, conducts the same business as HMCA. HMCA and HDM provide management services, administrative services, billing and collection services, office space, equipment, repair, maintenance service, and clerical and other non-medical personnel to medical providers, engaged in diagnostic imaging. HDM, however, in addition to acting as a management company, owns and operates four diagnostic imaging facilities in Florida, where the corporate practice of medicine is permitted.

Fonar is engaged in the business of designing, manufacturing, selling and servicing magnetic resonance imaging scanners, also referred to as "MRI" or "MR" scanners, which utilize MRI technology for the detection and diagnosis of human disease, abnormalities, other medical conditions and injuries. Fonar's founders built the first scanner in 1977 and Fonar introduced the first commercial MRI scanner in 1980. Fonar is also the originator of the iron-core non-superconductive and permanent magnet technology.

Fonar's iron frame technology made Fonar the originator of "open" MRI scanners. We introduced the first "open" MRI in 1980. Since that time we have concentrated on further application of our "open" MRI, introducing most recently the Upright® Multi-Position™ MRI scanner (also referred to as the "Upright®" or "Stand-Up®" MRI scanner) and the Fonar 360™ MRI scanner. (The Fonar 360™ MRI is not presently being marketed).

The product we are promoting is our Upright® MRI. Our patented Upright® MRI is unique in the industry in that it allows patients to be scanned in fully weight-bearing conditions, such as standing, sitting or bending in any position that causes adverse symptoms. This means that an abnormality or injury, such as a slipped disk can be visualized where it may not have been seen with the patient lying down. We have introduced the name "Upright®" as an alternative to "Stand-Up®" because of the multiplicity of positions in which the patient may be scanned where the patient is not standing.

See Note 17 to the Consolidated Financial Statements for separate financial information regarding our medical equipment and physician and diagnostic management services segments.

## FONAR CORPORATION AND SUBSIDIARIES

### FORWARD LOOKING STATEMENTS.

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

### COMPANY OVERVIEW.

The Upright® MRI (also known as the "Stand-Up® MRI") is a "whole-body" MRI, meaning it can be used to scan any part of the body. Unlike conventional recumbent MRI scanners, the Upright® MRI permits MRI diagnoses to be made in the weight-bearing state. The Upright® MRI allows patients to be scanned while standing, sitting, bending or lying down. This means that an abnormality or injury, such as a slipped disk, may be scanned under full weight-bearing conditions, which more often than not is the position in which patients experience pain. An adjustable bed allows patients to stand, sit or lie on their backs, sides or stomachs. The Upright® MRI is by design, a non-claustrophobic MRI scanner.

Although we are emphasizing sales of the Upright® MRI, because of uncertain economic conditions and the resulting weakening demand, revenues recognized from the sale of Upright® MRI scanners decreased in fiscal 2014 by 70.26% from fiscal 2013 (approximately \$3.2 million in fiscal 2013 compared to approximately \$957,000 in fiscal 2014). Note that we recognize revenue on a percentage of completion basis. Accordingly, revenue is recognized as each sub-assembly of a scanner is manufactured. Consequently the revenues for a fiscal period do not necessarily relate to orders placed in that period or payments received.

The Company completed a private placement of equity and succeeded in raising \$6,000,000 on May 2, 2011. The offering consisted of Preferred Class A membership interests in a newly formed limited liability company, Imperial Management Services, LLC ("Imperial"). Class B membership interests, all of which were retained by the Company's subsidiary, HMCA, hold a 90% equity interest in Imperial. The Class A membership interests are entitled to receive a dividend of 18% per annum of their capital contributions to the limited liability company. HMCA contributed all of its assets, together with its liabilities, to Imperial as HMCA's capital contribution.

On February 13, 2013, HMCA entered into an agreement to acquire a 50.5% interest in Health Diagnostics Management, LLC ("HDM"). On March 5, 2013 HDM purchased from Health Diagnostics, LLC ("HD") and certain of its subsidiaries, a business managing 14 MRI scanning centers, located in the States of New York and Florida for a total

purchase price aggregating \$35.9 million.

As a result of the Imperial and HDM transactions, as of August 31, 2014, HMCA through Imperial and HDM, managed a total of 24 MRI scanning centers, 17 of which are located in New York and 7 of which are located in Florida, and 23 of which have Upright MRI scanners.

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## FONAR CORPORATION AND SUBSIDIARIES

### MEDICAL EQUIPMENT SEGMENT

#### PRODUCTS

The Fonar Upright® MRI is a weight-bearing whole-body open MRI system which enables positional MRI (pMRI®) applications. Operating at a magnetic field strength of 0.6 Tesla, the scanner is a powerful, diagnostically versatile and cost-effective open MRI that provides a broad range of clinical capabilities and a complete set of imaging protocols. Patients can be scanned standing, bending, sitting, upright at an intermediate angle and in the conventional recumbent position. This multi-positional MRI system accommodates an unrestricted range of motion for flexion, extension, lateral bending, and rotation studies of the cervical (upper) and lumbar (lower) spine. Previously difficult patient scanning positions can be achieved and compared using the system's MRI-compatible, three-dimensional, motorized patient handling system. The system's lift and tilt functions deliver the targeted anatomical region to the center of the magnet. True image orientation is assured, regardless of the rotation angle, via computer read-back of the table's position.

There is considerable evidence that the weight-bearing Upright® MRI provides medical benefits not duplicated by any other MRI scanner because patient positioning plays a critical role in detecting clinically significant pathology.

For instance, the Fonar Upright® technology has demonstrated its key value on patients with the Arnold-Chiari Syndrome, cerebellar tonsil ectopia (CTE), which is believed to affect 200,000 to 500,000 Americans. In this syndrome, brain stem compression and subsequent severe neurological symptoms occur in these patients, when because of weakness in the support tissues within the skull, the brain stem descends and is compressed and entrapped at the base of the skull in the foramen magnum, which is the circular bony opening at the base of the skull where the spinal cord exits the skull. The brain structures "entrapped" in Chiari Syndrome are the lowest lying structures of the brain, the tonsils of the cerebellum. The Chiari Syndrome is therefore alternately named Cerebellar Ectopia (CTE) indicating the displacement (ectopia) of these Cerebellar tonsils in this syndrome. Classic symptoms of the Chiari Syndrome include the "drop attack," where the patient unexpectedly experiences an explosive rush or nervous discharge at the base of the brain which rushes down the body to the extremities, causing the patient to collapse in a temporary neuromuscular paralysis; this subsides when the patient is lying down. Conventional lie-down MRI scanners cannot make an adequate evaluation of the pathology since the patient's pathology is most visible and the symptoms most acute when the patient is scanned in the upright weight-bearing position.

A publication in the Journal "Brain Injury" (Brain Injury 2010, 24 (7-8) 988-994) of 1,200 neck pain patients reported that the fallen cerebellar tonsils of the brain (CTE) were missed 75% of the time when the patient was scanned only in the recumbent position. It is critical to have an image of the patient in an upright position so that the neurosurgeons can fully evaluate the extent of the brain stem compression which is occurring so they can choose the most appropriate surgical approach for the operative repair.

The study was published by 10 authors from distinguished universities in the United States and around the world. The study reported that Cerebellar Tonsil Herniation (CTE) was missed 75% of the time when the patient was scanned lying down instead of upright. At the current rate of 1,000,000 automobile whiplash injuries in the U.S. per year, 600,000 patients each year would have the pathology responsible for their symptoms go undetected if they were examined solely in a conventional recumbent-only MRI.

The Upright® MRI has also demonstrated its value for patients suffering from scoliosis. Scoliosis patients have been typically subjected to routine x-ray exams for years and must be imaged upright for an adequate evaluation of their



scoliosis. Because the patient must be standing for the exam, an x-ray machine has been the only modality that could provide that service. The Upright® MRI, is the only MRI scanner which allows the patient to stand during the MRI exam. Fonar has developed a new RF receiver and scanning protocol that for the first time allows scoliosis patients to obtain diagnostic pictures of their spines without the risks of x-rays. A study by the National Cancer Institute (2000) of 5,466 women with scoliosis reported a 70% increase in breast cancer resulting from 24.7 chest x-rays these patients received on the average in the course of their scoliosis treatment.

## FONAR CORPORATION AND SUBSIDIARIES

The Upright® MRI is also the world's most non-claustrophobic whole-body MRI scanner. Patients can simply walk into the magnet, stand or sit for their scans and then walk out. The magnet's front-open and top-open design provides an unprecedented degree of comfort because there is nothing in front of the patient's face except for a large (42") flat-screen TV that is mounted on the wall. The default position for the bed is a tilt back of seven degrees that minimizes patient motion. Special coil fixtures, a patient seat, Velcro straps, and transpolar stabilizing bars are also used to keep the patient comfortable and motionless throughout the scanning process.

Full-range-of-motion studies of the joints in a multiple of directions are possible, an especially promising feature for sports injuries. Full Range of Motion cines, or movies, of the lumbar spine can also be achieved under full body weight.

The Fonar 360™ is an enlarged room sized magnet in which the floor, ceiling and walls of the scan room are part of the magnet frame. Consequently, this scanner allows 360 degree access to the patient, and physicians and family members are able to enter the scanner and approach the patient.

Although the Fonar 360™ MRI is not now being actively marketed, the first Fonar 360™ MRI scanner, installed at the Oxford-Nuffield Orthopedic Center in Oxford, United Kingdom, is carrying a full diagnostic imaging caseload.

The Upright® MRI is designed to maximize image quality through an optimal combination of signal-to-noise (S/N) and contrast-to-noise (C/N) ratios. The technical improvements realized in this scanner's design over its lower field strength predecessors also include increased image-processing speed and diagnostic flexibility.

Fonar created the high-field open MRI market segment. High-field open MRIs operate at significantly higher magnetic field strengths than the 0.2-0.35 Tesla open MRIs that preceded them, and, therefore, benefit from more of the MRI image-producing signal needed to make high-quality MRI images.

Fonar maximizes image quality through an optimal combination of image signal to noise (S/N) and contrast-to noise (C/N) ratios. Technical improvements incorporated into the scanner design include increased image processing speed, high-S/N Organ Specific(TM) RF receiver coils, high performance front-end electronics featuring high-speed, wide-dynamic-range analog-to-digital conversion and a miniaturized ultra-low-noise pre-amplifier; high-speed automatic tuning, bandwidth-optimized pulse sequences, multi-bandwidth sequences, and off-center FOV imaging capability.

In addition to the signal-to-noise ratio, however, a major determinant of that must be considered when it comes to image quality is contrast, the quality that enables reading physicians to clearly distinguish adjacent, and sometimes minute, anatomical structures from their surroundings. This quality is measured by contrast-to-noise ratios (C/N). Unlike S/N, which increases with increasing field strength, relaxometry studies have shown that C/N peaks in the mid-field range and actually falls off precipitously at higher field strengths. The Upright® MRI scanners operate squarely in the optimum C/N range.

FONAR's scanners provide various features allowing for versatile diagnostic capability. For example, SMART™ scanning allows for same-scan customization of up to 63 slices, each slice with its own thickness, resolution, angle and position. This is an important feature for scanning parts of the body that include small-structure sub-regions requiring finer slice parameters. There is also Multi-Angle Oblique™ (MAO) imaging, and oblique imaging.

The console for these scanners includes a mouse-driven, multi-window interface for easy operation and a 42-inch, 1280 x 1024-pixel, 20-up, high-resolution image monitor with features such as electronic magnifying glass and real-time, continuous zoom and pan.

During fiscal 2014, sales of our Upright® MRI scanners accounted for approximately 1.4% of our total revenues and 7.9% of our medical equipment revenues, as compared to 6.5% of total revenues and 21.6% of medical equipment revenues in fiscal 2013. These results reflect the decrease in our sales of scanners.

Our principal selling, marketing and advertising efforts have been focused on the Upright® MRI, which we believe is a particularly unique product, being the only MRI scanner which is both open and allows for weight-bearing imaging. We expect to continue our focus on the Upright® MRI in the immediate future.

## FONAR CORPORATION AND SUBSIDIARIES

The materials and components used in the manufacture of our products (circuit boards, computer hardware components, electrical components, steel and plastic) are generally available at competitive prices. We have not had difficulty acquiring such materials.

## WORKS-IN-PROGRESS

All of our products and works-in-progress seek to bring to the public MRI products that are expected to provide important advances against serious disease.

MRI takes advantage of the nuclear resonance signal elicited from the body's tissues and the exceptional sensitivity of this signal for detecting disease. Much of the serious disease of the body occurs in the soft tissue of vital organs. The principal diagnostic modality currently in use for detecting disease, as in the case of x-ray mammography, are diagnostic x-rays. X-rays discriminate soft tissues, such as healthy breast tissue and cancerous tissue poorly, because the x-ray particle traverses the various soft tissues almost equally thereby causing target films to be nearly equally exposed by x-rays passing through adjacent soft tissues and creating healthy and cancerous shadows on the film that differ little in brightness. The image contrast in x-ray between cancerous and healthy breast tissue is poor, making the detection of breast cancers by the x-ray mammogram less than optimal and forcing the mammogram to rely on the presence or absence of microscopic stones called "microcalcifications" instead of being able to "see" the breast cancer itself. If microcalcifications are not present to provide the missing contrast, then the breast cancer goes undetected. They frequently are not present. The maximum contrast available by x-ray with which to discriminate disease is 4%. Brain cancers differ from surrounding healthy brain by only 1.6% while the contrast in the brain by MRI is 25 times greater at 40%. X-ray contrasts among the body's soft tissues are maximally 4%. Their contrast by MRI is 32.5 times greater (130%).

The soft tissue contrasts with which to distinguish cancers on images by MRI are up to 180%. In the case of cancer these contrasts can be even more marked making cancers readily visible and detectable anywhere in the body. This is because the nuclear resonance signals from the body's tissues differ so dramatically. Liver cancer and healthy liver signals differ by 180% for example. Thus there is some urgency to bring to market an MRI based breast scanner that can overcome the x-ray limitation and assure that mammograms do not miss serious lesions. The added benefit of MRI mammography relative to x-ray mammography is the elimination of the need for the patient to disrobe and the painful compression of the breast typical of the x-ray mammogram. The patient is scanned in her street clothes in MRI mammography. Moreover MRI mammogram scans the entire chest wall including the axilla for the presence of nodes which the x-ray mammogram cannot reach.

We view our Upright® MRI as having the potential for being an ideal breast examination machine as it permits the patient to be seated for the examination, which would allow easy access for an MRI guided breast biopsy when needed. The Fonar 360™ MRI scanner would also be ideal for breast examinations.

## PRODUCT MARKETING

The principal markets for the Company's scanners are private diagnostic imaging centers and hospitals.

We use internal and independent manufacturer's representatives for domestic and foreign markets. None of Fonar's competitors are entitled to make the Fonar Upright® MRI scanner.

Fonar's Website includes interactive product information for reaching customers.

Fonar has targeted orthopedic surgeons and neurosurgeons, particularly spine surgeons, as important markets for the Upright® MRI. Accordingly, Fonar has exhibited at annual meetings of The American Academy of Orthopaedic Surgeons (AAOS); the North American Spine Society (NASS); the American Association of Neurological Surgeons (AANS); and the Congress of Neurological Surgeons (CNS).

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## FONAR CORPORATION AND SUBSIDIARIES

Recognition of the importance of the Fonar Upright® MRI continues to grow. During fiscal 2014, sales were made to customers in Dubai, United Arab Emirates, Wasilla, Alaska and to Medserena in Frankfurt, Germany. CEO Matthais Schulz has said, “The large number of requests coming from our physicians in Germany are arising because of the special medical need for FONAR’s unique technology. This is in spite of an intensely active MRI market in Germany, where there are already many conventional lie-down MRIs installed.” Medserena also has expanded its market to the United Kingdom with the opening of a Fonar Upright® MRI scanner in London.

Even high-field 3.0 Tesla MRI scanners cannot overshadow the importance of Fonar’s unique technology. In August, 2010, a distinguished board-certified radiologist in Florida, the owner/operator of two multi-modality imaging centers equipped with MRIs, ordered a Fonar Upright® MRI. He initially considered purchasing a 3.0 Tesla lie-down MRI, but decided instead to buy the Fonar Upright® Multi-Position™ MRI when he became aware of its many unique imaging capabilities.

Fonar’s marketing strategy has been designed to reach key purchasing decision makers with information concerning our flagship product, the Upright® MRI. This has led to many inquiries and to some sales of the Upright® MRI scanner and is intended to increase Fonar’s presence in the medical market. Fonar’s advertising has been directed at four target audiences: neurosurgeons, orthopaedic surgeons, radiologists and physicians in general.

- 1) Neurosurgeons and Orthopaedic Surgeons: These are the surgeons who can most benefit from the superior diagnostic benefits of the Fonar Upright® MRI with its Multi-Position® diagnostic ability. Advertisements to them have appeared in the journal Spine, The Journal of Neurosurgery, and the Journal of the American Academy of Orthopedic Surgery.
- 2) Radiologists: This segment of the campaign is aimed at the physicians who now have a new modality to offer their referring physicians. Our advertisements directed to them have appeared in Radiology and Diagnostic Imaging.
- 3) All Physicians: These advertising efforts have been directed to the total physician audience, so that the vast number of doctors who send patients for MRI’s are aware of the diagnostic advantages of the Fonar Upright® Multi-Position® MRI. Advertisements directed to this audience have appeared in the Journal of the American Medical Association.

This advertising has featured a series of compelling messages. One advertisement pointed out that the AMA book, Guides to the Evaluation of Permanent Impairment, indicates that diagnosis must be performed upright in flexion and extension. Another advertisement was educational and headlined, “Discover the power of Upright Imaging”. Fonar realizes that peer-to-peer communications is the most powerful way to speak to physicians. Consequently, testimonials from surgeons and radiologists have been used to promote our Upright® MRI scanner. The first such advertisement featured five surgeons and two radiologists, explaining the Multi-Position® diagnostic benefits of the Fonar Upright® MRI scanner to them. Another advertisement featured a leading radiologist, telling why he bought 12 Fonar Upright® MRI scanners and planned to buy more.

Also, our advertising for HMCA also serves as advertising for Fonar MRI scanners. We have increased internet awareness of our product by driving patient traffic to the Upright® scanning centers we manage by installing Websites for every location. These websites and advertising give prospective customers of Upright® MRI scanners a view of operating Upright® MRI centers and the benefits of using an Upright® MRI scanner. The success of

HMCA-managed sites not only increases management fees to HMCA but encourages new sales for Fonar as well.

To meet the demand for high-field open MRI scanners, Fonar plans to devote its principal efforts to marketing the Upright® MRI. The Upright® MRI is the only scanner in the industry that has the unique capability of scanning patients under weight-bearing conditions and in various positions. Utilizing a 6000 gauss (0.6 Tesla field strength) iron core electromagnet, the Upright® MRI scanner magnets are among the highest field "Open MRI" scanners in the industry.

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## FONAR CORPORATION AND SUBSIDIARIES

The Upright® MRI is also suited to fill a demand for better diagnoses of scoliosis patients, who must be standing for the exam. Scoliosis patients are typically subjected to routine x-ray exams for years. In the past, an x-ray machine was the only modality that could provide that service. Typical MRI scanners cannot provide this service because the patient cannot stand up inside of them. The Fonar Upright™ MRI scanner is the only MRI scanner which allows the patient to stand during the exam. The Fonar Upright® Scanner avoids radiation of the x-ray machines currently used for scoliosis, which have been reported by the National Cancer Institute to cause a 70% increase in the risk of breast cancer. Other important new applications are Upright® imaging of the pelvic floor and abdomen to image prolapses and inguinal hernias. Fonar has also developed the first non-invasive method to image the prostate: the patient simply sits on a flat, seat-like coil.

We also will seek to introduce new MRI applications for our scanners such as MRI-directed interventions.

Our areas of operations are principally in the United States. During the fiscal year ended June 30, 2014, 2.5% of the Company's revenues were generated by foreign sales, as compared to 2.1% for fiscal 2013.

We are seeking to promote foreign sales and have sold scanners in various foreign countries. Foreign sales, however, have not yet proved to be a significant source of revenue.

## SERVICE AND UPGRADES FOR MRI SCANNERS

Our customer base of installed scanners has been and will continue to be an additional source of income, independent of direct sales.

Income is generated from the installed base in two principal areas, namely, service and upgrades. Service and maintenance revenues from our external installed base were approximately \$10.2 million in fiscal 2014 and \$11.0 million in fiscal 2013. Notwithstanding the decrease in service revenues in fiscal 2014, we expect service revenues to be essentially stable under present circumstances as customers enter into service contracts when the warranties on their scanners expire, replacing lost service contracts resulting from older scanners being taken out of service.

We also anticipate that our scanners will result in upgrades income in future fiscal years. The potential for upgrades income, originates in the versatility and productivity of the Upright® Imaging technology. New medical uses for MRI technology are constantly being discovered and are anticipated for the Upright® Imaging technology as well. New features can often be added to the scanner by the implementation of little more than versatile new software packages, which when coupled with hardware upgrades can add years of useful life to the scanner.

## RESEARCH AND DEVELOPMENT

During the fiscal year ended June 30, 2014, we incurred expenditures of \$1,760,821, none of which was capitalized, on research and development, as compared to \$1,438,560, none of which was capitalized, during the fiscal year ended June 30, 2013.



Research and development activities have focused principally on software improvements to the user interface of the MRI scanner. The Windows-based Sympulse™ platform controls all of the functions of the UPRIGHT® scanner except those of the versatile, multi-position patient table. Separate, dedicated, motion-control software is used to maneuver the UPRIGHT® bed, and development of this software is ongoing as well.

While software improvements to the user interface are important in their own right, significant value is added to the MRI scanner by the modification of existing protocols for examining various parts of the body, and the development of new protocols that utilize new underlying capabilities of the pulse sequence software. Over time, FONAR users have become accustomed to the steady improvement in the recommended clinical protocols that accompany new software releases. More significantly, in recent years we have seen increasing adoption of FONAR-recommended clinical protocols over those developed on site. This is a testament to the superior image quality they produce in attractively short scan times.

## FONAR CORPORATION AND SUBSIDIARIES

The development of clinically practical scan protocols and software depends on close contact between research and development scientists and engineers, and end users. That close contact is facilitated in part by the relationship with HMCA and the scanning centers. In addition to that collaboration, R&D staff have pursued a variety of novel and Upright® MRI-specific research projects. It is anticipated that these will ultimately lead to new applications that are made available to existing customers as upgrade add-ons to their machines. For example, phase-contrast imaging techniques originally developed for angiography have recently been applied to cerebro-spinal fluid (CSF) flow. Analysis of CSF flow in upright and recumbent postures may prove to be of significant value in the evaluation of a variety of disorders.

## BACKLOG

Our backlog of unfilled orders at September 10, 2014 was approximately \$2.9 million, as compared to \$1.5 million at September 26, 2013. It is expected that the existing backlog of orders will be filled within the 2015 fiscal year.

## PATENTS AND LICENSES

We currently have numerous patents in effect which relate to the technology and components of the MRI scanners.

We believe that these patents, and the know-how we have developed, are material to our business.

One of our patents, issued in the name of Dr. Damadian and licensed to Fonar, was United States patent No. 3,789,832, Apparatus and Method for Detecting Cancer in Tissue, also referred to in this report as the "1974 Patent". The 1974 Patent was the first of 4,552 (as of February 13, 2013) MRI patents issued by the United States Patent Office. The development of our MRI scanners have been based upon the 1974 Patent, and we believe that the 1974 Patent was the first of its kind to utilize MR to scan the human body and to detect cancer. The 1974 Patent was extended beyond its original 17-year term and expired in February, 1992.

We have significantly enhanced our patent position within the industry and now possesses a substantial patent portfolio which provides us, under the aegis of United States patent law, "the exclusive right to make, use and sell" many of the scanner features which Fonar pioneered and which are now incorporated in most MRI scanners sold by the industry. As of June 30, 2014, 189 patents had been issued to Fonar, and approximately 23 patents were pending. A number of Fonar's existing patents specifically relate to protecting Fonar's position in the Upright MRI market. The patents further enhance Dr. Damadian's pioneer patent, the 1974 Patent, that initiated the MRI industry and provided the original invention of MRI scanning. The terms of the patents in Fonar's portfolio extend to various times.

We also have patent cross-licensing agreements with other MRI manufacturers. We have not licensed, however, any technology relating to Upright® MRI scanning.

## PRODUCT COMPETITION

## MRI SCANNERS

A majority of the MRI scanners in use in hospitals and outpatient facilities and at mobile sites in the United States are based on high field (1.5-3.0 Tesla) air core super conducting magnet technology.

The remainder, described as Open MRIs, are recumbent-only machines based on Fonar's original iron-frame vertical magnetic field magnet design. These systems have been manufactured and sold by many of our largest competitors over the years. They generally operate at low field strengths (0.2 - 0.35 Tesla). Recently our competitors have attempted to introduce higher field strength Open MRI products, but the perception of the medical community is still that Open MRIs are useful only for anxious and claustrophobic patients, their image quality is poor, scan times are long, image resolution is low and they don't do anything clinically valuable that high-field MRIs don't already do.

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## FONAR CORPORATION AND SUBSIDIARIES

One of the Upright MRI's big competitive advantages is that it is dramatically different from the Open MRI in several important ways:

The Upright MRI actually does something clinically valuable that the high-field MRI machines cannot do (i.e. positional imaging, weight-bearing imaging).

Although the patient can extend their arms and possibly see out the sides while recumbent in an Open MRI, there is still a large intimidating magnet pole very close to and directly in front of the patient's face. The Upright MRI allows the patient look directly out of the scanner and watch TV because there is nothing in front of their face.

The Upright MRI uses the same configuration RF receiver coil as a high-field MRI system to image the spine. Open MRIs cannot do this. (This is because of the rule in MRI that the axis of symmetry of the RF receiver coil should be perpendicular to the direction of the main magnetic field. The upright patient sits comfortably with their back against a flat ("planar") RF receiver coil in our horizontal transaxial magnetic field. In contrast, the vertical magnetic field in the recumbent-only Open MRI precludes the use of this type of receiver coil).

The Upright® MRI's magnetic field strength is 2-3 times that of many Open MRIs still in operation today.

Relative the high-field systems, the Upright® MRI's has two major competitive advantages:

Patient positioning sometimes trumps a small increase in the image resolution and decrease in the scan time. As it is critical for physicians to not "miss" anything in the images, they recognize that the position-dependent pathology visualized with the Upright® MRI will be invisible ("missed") if their patients are scanned at a higher field strengths.

Image artifacts arising from metal implants such as surgical screws are diminished with the 0.6 Tesla Upright® MRI compared to those from the high-field MRIs. It is well known that such artifacts get smaller as the MRI magnet's field strength is reduced, so the anatomy adjacent to implanted hardware will be less obscured with the Upright® MRI. This is particularly valuable for surgeons referring their postoperative patients for diagnostic imaging studies.

Fonar faces competition within the MRI industry from such firms as General Electric Company, Philips N.V., Toshiba Corporation, Hitachi Corporation and Siemens A.G. Most competitors have marketing and financial resources more substantial than those available to us. They have in the past, and may in the future, heavily discount the sales price of their scanners. Such competitors sell both high field air core superconducting MRI scanners and iron frame products. Fonar's original iron frame design, ultimately imitated by Fonar's competitors to duplicate Fonar's origination of "Open" MRI magnets, gave rise to current patient protected Upright® MRI technology with the result that Fonar today is the unique and only supplier of the highest field MRI magnets (.6 Tesla) that are not superconducting, do not use liquid helium and are not therefore susceptible to severe consequences and downtime cause by a system quench.

The iron frame, because it controls the magnetic lines of force and place them where wanted and remove them from where not wanted, provides a more versatile magnet design than is possible with air core magnets. Air core magnets contain no iron but consist entirely of turns of current carrying wire.

Fonar expects to be the leader in weight-bearing and positional MRI for providing dynamic visualization of body parts including the spine and extremities. No other company possesses the patented Upright® MRI technology necessary to achieve Upright positional MRI imaging.

#### OTHER IMAGING MODALITIES

Fonar's MRI scanners also compete with other diagnostic imaging systems, all of which are based upon the ability of energy waves to penetrate human tissue and to be detected by either photographic film or electronic devices for presentation of an image on a television monitor. Three different kinds of energy waves - X-ray, gamma and sound - are used in medical imaging techniques which compete with MRI medical scanning, the first two of which involve exposing the patient to potentially harmful radiation. These other imaging modalities compete with MRI products on the basis of specific applications.

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## FONAR CORPORATION AND SUBSIDIARIES

X-rays are the most common energy source used in imaging the body and are employed in three imaging modalities:

1. Conventional X-ray systems, the oldest method of imaging, are typically used to image bones and teeth. The image resolution of adjacent structures that have high contrast, such as bone adjacent to soft tissue, is excellent, while the discrimination between soft tissue organs is poor because of the nearly equivalent penetration of x-rays.
2. Computerized Tomography, also referred to as "CT", systems couple computers to x-ray instruments to produce cross-sectional images of particular large organs or areas of the body. The CT scanner addresses the need for images, not available by conventional radiography, that display anatomic relationships spatially. However, CT images are generally limited to the transverse plane and cannot readily be obtained in the two other planes, sagittal and coronal. Improved picture resolution is available at the expense of increased exposure to x-rays from multiple projections. Furthermore, the pictures obtained by this method are computer reconstructions of a series of projections and, once diseased tissue has been detected, CT scanning cannot be focused for more detailed pictorial analysis or obtain a chemical analysis.
3. Digital radiography systems add computer image processing capability to conventional x-ray systems. Digital radiography can be used in a number of diagnostic procedures which provide continuous imaging of a particular area with enhanced image quality and reduced patient exposure to radiation.

Nuclear medicine systems, which are based upon the detection of gamma radiation generated by radioactive pharmaceuticals introduced into the body, are used to provide information concerning soft tissue and internal body organs and particularly to examine organ function over time.

Ultrasound systems emit, detect and process high frequency sound waves reflected from organ boundaries and tissue interfaces to generate images of soft tissue and internal body organs. Although the images are substantially less detailed than those obtainable with x-ray methods, ultrasound is generally considered harmless and therefore has found particular use in imaging the pregnant uterus.

X-ray machines, ultrasound machines, digital radiography systems and nuclear medicine compete with the MRI scanners by offering significantly lower price and space requirements. However, Fonar believes that the quality of the images produced by its MRI scanners is generally superior to the quality of the images produced by those other methodologies.

## GOVERNMENT REGULATION

### FDA Regulation

The Food and Drug Administration in accordance with Title 21 of the Code of Federal Regulations regulates the manufacturing and marketing of Fonar's MRI scanners. The regulations can be classified as either pre-market or post-market. The pre-market requirements include obtaining marketing clearance, proper device labeling, establishment registration and device listing. Once the products are on the market, Fonar must comply with post-market surveillance controls. These requirements include the Quality Systems Regulation, or "QSR", also known as Current Good Manufacturing Practices or CGMPs, and Medical Device Reporting, also referred to as MDR regulations. The QSR is a quality assurance requirement that covers the design, packaging, labeling and

manufacturing of a medical device. The MDR regulation is an adverse event-reporting program.

#### Classes of Products

Under the Medical Device Amendments of 1976 to the Federal Food, Drug and Cosmetic Act, all medical devices are classified by the FDA into one of three classes. A Class I device is subject only to general controls, such as labeling requirements and manufacturing practices; a Class II device must comply with certain performance standards established by the FDA; and a Class III device must obtain pre-market approval from the FDA prior to commercial marketing. Fonar's products are Class II devices. Class II devices are subject to "General Controls"; General Controls include:

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## FONAR CORPORATION AND SUBSIDIARIES

1. Establishment registration of companies which are required to register under 21 CFR Part 807.20, such as manufacturers, distributors, re-packagers and re-labelers.
2. Medical device listing with FDA of devices to be marketed.
3. Manufacturing devices in accordance with the Current Good Manufacturing Practices Quality System Regulation in 21 CFR Part 820.
4. Labeling devices in accordance with labeling regulations in 21 CFR Part 801 or 809.
5. Submission of a Premarket Notification, pursuant to 510(k), before marketing a device.

In addition to complying with general controls, Class II devices are also subject to special controls. Special controls may include special labeling requirements, guidance documents, mandatory performance standards and post-market surveillance.

On October 3, 2000 Fonar received FDA clearance for the Upright® MRI.

### Premarketing Submission

Each person who wants to market Class I, II and some III devices intended for human use in the U.S. must submit a 510(k) to FDA at least 90 days before marketing unless the device is exempt from 510(k) requirements. A 510(k) is a pre-marketing submission made to FDA to demonstrate that the device to be marketed is as safe and effective, that is, substantially equivalent, SE, to a legally marketed device that is not subject to pre-market approval, PMA. Applicants must compare their 510(k) device to one or more similar devices currently on the U.S. market and make and support their substantial equivalency claims.

The FDA is committed to a 90-day clearance after submission of a 510(k), provided the 510(k) is complete and there is no need to submit additional information or data.

The 510(k) is essentially a brief statement and description of the product. As Fonar's scanner products are Class II products, there are no pre-market data requirements.

An investigational device exemption, also referred to as IDE, allows the investigational device to be used in a clinical study pending FDA clearance in order to collect safety and effectiveness data required to support the Premarket Approval, also referred to as PMA, application or a Premarket Notification pursuant to 510(k), submission to the FDA. Clinical studies are most often conducted to support a PMA.

For the most part, however, we have not found it necessary to utilize IDE's. The standard 90 day clearance for our new MRI scanner products classified as Class II products makes the IDE unnecessary, particularly in view of the time and effort involved in compiling the information necessary to support an IDE.

### Quality System Regulation

The Quality Management System is applicable to the design, manufacture, administration of installation and servicing of magnetic resonance imaging scanner systems. The FDA has authority to conduct detailed inspections of



manufacturing plants, to establish Good Manufacturing Practices which must be followed in the manufacture of medical devices, to require periodic reporting of product defects and to prohibit the exportation of medical devices that do not comply with the law.

#### Medical Device Reporting Regulation

Manufacturers must report all MDR reportable events to the FDA. Each manufacturer must review and evaluate all complaints to determine whether the complaint represents an event which is required to be reported to FDA. Section 820.3(b) of the Quality Systems regulation defines a complaint as, "any written, electronic or oral communication that alleges deficiencies related to the identity, quality, durability, reliability, safety, effectiveness, or performance of a device after it is released for distribution."

A report is required when a manufacturer becomes aware of information that reasonably suggests that one of their marketed devices has or may have caused or contributed to a death, serious injury, or has malfunctioned and that the device or a similar device marketed by the manufacturer would be likely to cause or contribute to a death or serious injury if the malfunction were to recur.

## FONAR CORPORATION AND SUBSIDIARIES

Malfunctions are not reportable if they are not likely to result in a death, serious injury or other significant adverse event experience.

A malfunction which is or can be corrected during routine service or device maintenance still must be reported if the recurrence of the malfunction is likely to cause or contribute to a death or serious injury if it were to recur.

We have established and maintained written procedures for implementation of the MDR regulation. These procedures include internal systems that:

provide for timely and effective identification, communication and evaluation of adverse events;

provide a standardized review process and procedures for determining whether or not an event is reportable; and

provide procedures to insure the timely transmission of complete reports.

These procedures also include documentation and record keeping requirements for:

information that was evaluated to determine if an event was reportable;

all medical device reports and information submitted to the FDA;

any information that was evaluated during preparation of annual certification reports; and

systems that ensure access to information that facilitates timely follow up and inspection by FDA.

### FDA Enforcement

FDA may take the following actions to enforce the MDR regulation:

#### FDA-Initiated or Voluntary Recalls

Recalls are regulatory actions that remove a hazardous, potentially hazardous, or a misbranded product from the marketplace. Recalls are also used to convey additional information to the user concerning the safe use of the product. Either FDA or the manufacturer can initiate recalls.

There are three classifications, i.e., I, II, or III, assigned by the Food and Drug Administration to a particular product recall to indicate the relative degree of health hazard presented by the product being recalled.

#### Class I

Is a situation in which there is a reasonable probability that the use of, or exposure to, a violative product will cause serious adverse health consequences or death.

#### Class II

Is a situation in which use of, or exposure to, a violative product may cause temporary or medically reversible adverse health consequences or where the probability of serious adverse health consequences is remote.

### Class III

Is a situation in which use of, or exposure to, a violative product is not likely to cause adverse health consequences.

Fonar has initiated five voluntary recalls. Four of the recalls were Class II and one was Class III. The recalls involved making minor corrections to the product in the field. Frequently, corrections which are made at the site of the device are called field corrections as opposed to recalls.

### Civil Money Penalties

The FDA, after an appropriate hearing, may impose civil money penalties for violations of the FD&C Act that relate to medical devices. In determining the amount of a civil penalty, FDA will take into account the nature, circumstances, extent, and gravity of the violations, the violator's ability to pay, the effect on the violator's ability to continue to do business, and any history of prior violations.

## FONAR CORPORATION AND SUBSIDIARIES

### Warning Letters

FDA issues written communications to a firm, indicating that the firm may incur more severe sanctions if the violations described in the letter are not corrected. Warning letters are issued to cause prompt correction of violations that pose a hazard to health or that involve economic deception. The FDA generally issues the letters before pursuing more severe sanctions.

### Seizure

A seizure is a civil court action against a specific quantity of goods which enables the FDA to remove these goods from commercial channels. After seizure, no one may tamper with the goods except by permission of the court. The court usually gives the owner or claimant of the seized merchandise approximately 30 days to decide a course of action. If they take no action, the court will recommend disposal of the goods. If the owner decides to contest the government's charges, the court will schedule the case for trial. A third option allows the owner of the goods to request permission of the court to bring the goods into compliance with the law. The owner of the goods is required to provide a bond or, security deposit, to assure that they will perform the orders of the court, and the owner must pay for FDA supervision of any activities by the company to bring the goods into compliance.

### Citation

A citation is a formal warning to a firm of intent to prosecute the firm if violations of the FD&C Act are not corrected. It provides the firm an opportunity to convince FDA not to prosecute.

### Injunction

An injunction is a civil action filed by FDA against an individual or company. Usually, FDA files an injunction to stop a company from continuing to manufacture, package or distribute products that are in violation of the law.

### Prosecution

Prosecution is a criminal action filed by FDA against a company or individual charging violation of the law for past practices.

### Foreign and Export Regulation

We obtain approvals as necessary in connection with the sales of our products in foreign countries. In some cases, FDA approval has been sufficient for foreign sales as well. Our standard practice has been to require either the distributor or the customer to obtain any such foreign approvals or licenses which may be required.

Legally marketed devices that comply with the requirements of the Food Drug & Cosmetic Act require a Certificate to Foreign Government issued by the FDA for export. Other devices that do not meet the requirements of the FD&C Act but comply with the laws of a foreign government require a Certificate of Exportability issued by the FDA. All products which we sell have FDA clearance and would fall into the first category.

Foreign governments have differing requirements concerning the import of medical devices into their respective jurisdictions. The European Union, also referred to as EU, has some essential requirements described in the EU's

Medical Device Directive, also referred to as MDD. In order to export to one of these countries, we must meet the essential requirements of the MDD and any additional requirements of the importing country. The essential requirements are similar to some of the requirements mandated by the FDA. In addition the MDD requires that we enlist a Notified Body to examine and assess our documentation, a Technical Construction File, and verify that the product has been manufactured in conformity with the documentation. The notified body must carry out or arrange for the inspections and tests necessary to verify that the product complies with the essential requirements of the MDD, including safety performance and Electromagnetic Compatibility, also referred to as EMC. Also required is a Quality System, ISO-9001, assessment by the Notified Body. We were approved for ISO 9001 certification for its Quality Management System in April, 1999.

We received clearance to sell the Upright® MRI scanners in the EU in May, 2002.

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## FONAR CORPORATION AND SUBSIDIARIES

Other countries require that their own testing laboratories perform an evaluation of our devices. This requires that we must bring the foreign agency's personnel to the USA to perform the evaluation at our expense before exporting.

Some countries, including many in Latin America and Africa, have very few regulatory requirements, beyond FDA clearance.

To date, Fonar has been able to comply with all foreign regulatory requirements applicable to its export sales.

## HEALTH MANAGEMENT CORPORATION OF AMERICA

### IMPERIAL MANAGEMENT SERVICES, LLC

### HEALTH DIAGNOSTICS MANAGEMENT, LLC

## PHYSICIAN AND DIAGNOSTIC SERVICES MANAGEMENT BUSINESS

Health Management Corporation of America, formed under the name U.S. Health Management Corporation and referred to as "HMCA", was organized by FONAR in March 1997. HMCA was formed as a wholly-owned subsidiary to engage in the business of providing comprehensive management services to diagnostic imaging facilities. The services we provide include development, administration, leasing of office space, facilities and equipment, provision of supplies, staffing, training and supervision of non-medical personnel, credentialing, accounting, billing and collection, assistance with compliance matters and the development and implementation of practice growth and marketing strategies.

In May 2011, HMCA transferred all of its assets, liabilities and business to Imperial Management Services, LLC, a limited liability company which is controlled but not wholly-owned by HMCA. Imperial is continuing the business of HMCA utilizing the same facilities, equipment and personnel as HMCA. This transaction did not result in a change of control or policy, but was solely a means to raise capital.

On February 13, 2013, HMCA entered into an agreement with investors to acquire a 50.5% controlling interest in a newly formed limited liability company, Health Diagnostics Management, LLC (HDM).

On March 5, 2013 HDM purchased from Health Diagnostics, LLC ("HD") and certain of its subsidiaries, a business managing twelve (12) Stand-Up® MRI Centers and two (2) other scanning centers located in the States of New York and Florida. The transfer of the Florida facilities took place in April, 2013, following some required regulatory approvals.

HMCA is the controlling, but not sole owner of these two limited liability companies, Imperial and HDM, through which HMCA conducts its business. The investors are passive investors, in that their membership interests do not give them the right to participate in the management of either company.

As of September 5, 2014, HMCA and HDM managed a total of 24 MRI centers. For the 2013 fiscal year, the revenues HMCA and HDM recognized from the MRI facilities increased to \$34.3 million, and in fiscal 2014 the revenues recognized from the MRI facilities further increased to \$56.6 million.

For the sake of simplicity and to avoid confusion, HMCA, Imperial and HDM are, unless otherwise indicated referred to as “HMCA” for all periods before and after the Imperial and HDM transactions.

#### HMCA GROWTH STRATEGY

HMCA’s growth strategy focuses on upgrading and expanding the existing facilities it manages and expanding the number of facilities it manages for its clients. Our most important effort in this regard has been to promote and facilitate the replacement of existing MRI scanners with new Fonar Upright® MRI scanners. As a result, we presently have Upright® MRI scanners at all but one of the MRI facilities we manage.

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## FONAR CORPORATION AND SUBSIDIARIES

### PHYSICIAN AND DIAGNOSTIC MANAGEMENT SERVICES

HMCA's services to the facilities it manages encompass substantially all of their business operations. Each facility is controlled, however, by the physician owner, not HMCA, and all medical services are performed by the physicians and other medical personnel under the physician-owner's supervision. HMCA is the management company and performs services of a non-professional nature. These services include:

1. **Offices and Equipment.** HMCA identifies, negotiates leases for and/or provides office space and equipment to its clients. This includes technologically sophisticated medical equipment. HMCA also provides improvements to leaseholds, assistance in site selection and advice on improving, updating, expanding and adapting to new technology.
2. **Personnel.** HMCA staffs all the non-medical positions of its clients with its own employees, eliminating the client's need to interview, train and manage non-medical employees. HMCA processes the necessary tax, insurance and other documentation relating to employees.
3. **Administrative.** HMCA assists in the scheduling of patient appointments, purchasing of office and medical supplies and equipment and handling of reporting, accounting, processing and filing systems. It prepares and files the physician portions of complex applications to enable its clients to participate in managed care programs and to qualify for insurance reimbursement. HMCA assists the clients to implement programs and procedures to ensure full and timely regulatory compliance and appropriate cost reimbursement under no-fault insurance and Workers' Compensation guidelines, as well as compliance with other applicable governmental requirements and regulations, including HIPAA and other privacy requirements.
4. **Billing and Collections.** HMCA is responsible for the billing and collection of revenues from third-party payors including those governed by No-Fault and Workers' Compensation statutes. HMCA is presently using a third party to perform its billing and collection services for its clients' No-Fault and Workers' Compensation scanning business.
5. **Cost Saving Programs.** Based on available volume discounts, HMCA seeks to assist in obtaining favorable pricing for office and medical supplies, equipment, contrast agents, such as gadolinium, and other inventory for its clients.
6. **Diagnostic Imaging and Ancillary Services.** HMCA can offer access to diagnostic imaging equipment through diagnostic imaging facilities it manages. The Company may expand the ancillary services offered in its network to include x-rays and other MRI equipment such as extremity scanners.

**Marketing Strategies.** HMCA is responsible for developing and proposing marketing plans for its clients.

8. **Expansion Plans.** HMCA assists the clients in developing expansion plans including the opening of new or replacement facilities where appropriate.

HMCA's objective is to free physicians from as many non-medical duties as is practicable. Practices can treat patients more efficiently if the physicians can spend less time on business and administrative matters and more time practicing medicine.

HMCA provides its services pursuant to negotiated contracts with its clients. While HMCA believes it can provide the greatest value to its clients by furnishing the full range of services appropriate to that client, HMCA would also be willing to enter into contracts providing for a more limited spectrum of management services.



The exceptions to this general model of operation are four of the facilities acquired by HMCA from Health Diagnostics, LLC in April, 2013 in Florida. These Florida facilities are owned by limited liability companies which, as our subsidiaries, conduct their operations directly and bill and collect their fees from the patients and third party payors.

The facilities enter into contracts with third party payors, including managed care companies. None of HMCA's clients, however, participate in any capitated plans or other risk sharing arrangements. Capitated plans are those HMO programs where the provider is paid a flat monthly fee per patient.

## FONAR CORPORATION AND SUBSIDIARIES

The fees paid by the facilities to HMCA are flat monthly fees. In fiscal 2013, the aggregate amount of management fees were \$1,708,739 per month up to March 5, 2013. As a result of the HDM acquisition and the addition of 14 MRI scanning centers, the aggregate amount of management fees increased to \$3,469,438 per month commencing March 5, 2013. In fiscal 2014, the aggregate amount of management fees was \$3,483,916.

Fees under the management agreements are subject to adjustment by mutual agreement on an annual basis.

Dr. Damadian owns three of the MRI facilities in Florida managed by HMCA. The fees for these three sites in Florida owned by Dr. Damadian are flat monthly fees which are subject to adjustment by mutual agreement on an annual basis. In fiscal 2014, the aggregate amount of management fees paid to HMCA by these sites was \$615,144.

Patient fees for the Florida subsidiaries which directly bill their patients were \$24,307,192 in fiscal 2014.

HMCA and HDM contract with Tritech Healthcare Management (Plainview, New York) to perform billing and collection for their clients' No-Fault and Workers' Compensation business. The fixed monthly fees were \$30,000 for HMCA and \$55,000 for HDM in fiscal 2014.

## HMCA MARKETING

HMCA's marketing strategy is to expand the business and improve the facilities which it manages. HMCA is seeking to increase the number of locations of those facilities where market conditions are promising and to promote growth of our clients' and Florida subsidiaries' patient volume and revenue.

## DIAGNOSTIC IMAGING FACILITIES

Diagnostic imaging facilities managed by HMCA and HDM provide diagnostic imaging services to patients referred by physicians who are either in private practice or affiliated with managed care providers or other payor groups. The facilities are operated in a manner which eliminates the admission and other administrative inconveniences of in-hospital diagnostic imaging services. Imaging services are performed in an outpatient setting by trained medical technologists under the direction of physicians employed by the diagnostic imaging facilities. Following diagnostic procedures, the images are reviewed by the interpreting physicians who prepare a report of these tests and their findings. Reports for the New York facilities are transcribed by HMCA personnel and reports for the Florida facilities are outsourced to independent contractors.

HMCA develops marketing programs in an effort to establish and maintain profitable referring physician relationships and to maximize reimbursement yields. HMCA also directs its marketing efforts at managed care providers.

Managed care providers are an important factor in the diagnostic imaging industry. To further its position, HMCA is seeking to expand the imaging modalities offered at its managed and owned diagnostic imaging facilities. Two facilities in New York and two facilities in Florida have two MRI scanners. One facility in New York and two in Florida also perform x-rays.

REIMBURSEMENT

HMCA's clients receive reimbursements for their services through Medicare, Medicaid, managed care and other insurance.

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## FONAR CORPORATION AND SUBSIDIARIES

### Medicare

The Medicare program provides reimbursement for hospitalization, physician, diagnostic and certain other services to eligible persons 65 years of age and over and certain other individuals. Providers are paid by the federal government in accordance with regulations promulgated by the Department of Health and Human Services, HSS, and generally accept the payment with nominal deductible and co-insurance amounts required to be paid by the service recipient, as payment in full. Hospital inpatient services are reimbursed under a prospective payment system. Hospitals receive a specific prospective payment for inpatient treatment services based upon the diagnosis of the patient.

Under Medicare's prospective payment system for hospital outpatient services, or OPSS, a hospital is paid for outpatient services on a rate per service basis that varies according to the ambulatory payment classification group, or APC, to which the service is assigned rather than on a hospital's costs. Each year the Centers for Medicare and Medicaid Services, or CMS, publishes new APC rates that are determined in accordance with the promulgated methodology.

Services provided in non-hospital based freestanding facilities are paid under the Medicare Physician Fee Schedule, or MPFS. All of HMCA's clients are presently in this category. The MPFS is updated on an annual basis.

### Healthcare Reform Legislation

Healthcare reform legislation enacted in the first quarter of 2010 by the Patient Protection and Affordable Care Act or PPACA, specifically requires the U.S. Department of Health and Human Services, in computing physician practice expense relative value units, to increase the equipment utilization factor for advanced diagnostic imaging services (such as MRI, CT and PET) from a presumed utilization rate of 50% to 65% for 2010 through 2012, 70% in 2013, and 75% thereafter. Excluded from the adjustment are low-technology imaging modalities such as ultrasound, X-ray and fluoroscopy. The Health Care and Education Reconciliation Act of 2010 (H.R. 4872) or Reconciliation Act, which was approved by the President on March 30, 2010, amends the provision for higher presumed utilization of advanced diagnostic imaging services to a presumed rate of 75%. These changes may result in decreased revenue for the services performed by our clients for Medicare beneficiaries. Other changes in reimbursement for services rendered by Medicare Advantage plans may also reduce the revenues for services rendered to Medicare Advantage enrollees.

We have experienced reimbursement reductions for radiology services provided to Medicare beneficiaries, including reductions pursuant to the Deficit Reduction Act, or DRA.

The DRA, which became effective in 2007, set reimbursement for the technical component for imaging services (excluding diagnostic and screening mammography) in non-hospital based freestanding facilities at the lesser of OPSS or the MPFS.

In addition to the foregoing changes to the usage assumptions, CMS' 2010 regulatory changes to the MPFS also included a downward adjustment to services primarily involving the technical component rather than the physician work component, by adjusting downward malpractice payments for these services. These adjustments have been phased in over a four year period. For our fiscal year ended June 30, 2014, Medicare revenues represented approximately 6.5% of the revenues for HMCA's clients as compared to 7.6% for the fiscal year ended June 30, 2013. In January, 2014 additional reductions were adopted, and New York State is proposing to reduce workers' compensation reimbursements.

Because of the many variables involved, we are unable to predict how the legislative mandates contained in PPACA will be implemented, in their complete and final form, whether any additional changes to PPACA or regulations (including interpretations), will occur in the future, or what effect any other future legislation or regulation would have on our business. Many commercial insurance companies, however, tie their reimbursement rates to the government reimbursement levels.

## FONAR CORPORATION AND SUBSIDIARIES

### Medicaid

The Medicaid program is a jointly-funded federal and state program providing coverage for low-income persons. In addition to federally-mandated basic services, the services offered and reimbursement methods vary from state to state. In many states, Medicaid reimbursement is patterned after the Medicare program; however, an increasing number of states have established or are establishing payment methodologies intended to provide healthcare services to Medicaid patients through managed care arrangements. In fiscal 2014, approximately 0.25% of the revenues of HMCA's clients were attributable to Medicaid, as compared to 0.5% in fiscal 2013.

### Managed Care and Private Insurance.

Health Maintenance Organizations, or HMO's, Preferred Provider Organizations, or PPOs, and other managed care organizations attempt to control the cost of healthcare services by a variety of measures, including imposing lower payment rates, preauthorization requirements, limiting services and mandating less costly treatment alternatives. Managed care contracting is competitive and reimbursement schedules are at or below Medicare reimbursement levels. Some managed care organizations have reduced or otherwise limited, and other managed care organizations may reduce or otherwise limit, reimbursement in response to reductions in government reimbursement. These reductions could have an adverse impact on our financial condition and results of operations. These reductions have been, and any future reductions may be, similar to the reimbursement reductions proposed by CMS, Congress and the current federal government administration. The development and expansion of HMOs, PPOs and other managed care organizations within our core markets could have a negative impact on utilization of our services in certain markets and/or affect the revenues per procedure we can collect, since such organizations will exert greater control over patients' access to diagnostic imaging services, the selection of the provider of such services and the reimbursement thereof.

## HMCA COMPETITION

The physician and diagnostic management services field is highly competitive. A number of large hospitals have acquired medical practices and this trend may continue. HMCA expects that more competition will develop. Many competitors have greater financial and other resources than HMCA.

With respect to the diagnostic imaging facilities managed by HMCA, the outpatient diagnostic imaging industry is highly competitive. Competition focuses primarily on attracting physician referrals at the local market level and increasing referrals through relationships with managed care organizations, as well as emphasizing to potential referral sources the advantages of Upright® MRI scanning. HMCA believes that principal competitors for the diagnostic imaging centers are hospitals and independent or management company-owned imaging centers. Competitive factors include quality and timeliness of test results, ability to develop and maintain relationships with managed care organizations and referring physicians, type and quality of equipment, facility location, convenience of scheduling and availability of patient appointment times. HMCA believes that it will be able to effectively meet the competition in the outpatient diagnostic imaging industry with the Fonar Upright® MRI scanners at its facilities.

## GOVERNMENT REGULATION APPLICABLE TO HMCA

FEDERAL REGULATION

The healthcare industry is highly regulated and changes in laws and regulations can be significant. Changes in the law or new interpretation of existing laws can have a material effect on our permissible activities, the relative costs associated with doing business and the amount of reimbursement by government and other third-party payors.

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## FONAR CORPORATION AND SUBSIDIARIES

### Federal False Claims Act

The federal False Claims Act and, in particular, the False Claims Act's "qui tam" or "whistleblower" provisions allow a private individual to bring actions in the name of the government alleging that a defendant has made false claims for payment from federal funds. After the individual has initiated the lawsuit the government must decide whether to intervene in the lawsuit and to become the primary prosecutor. If the government declines to join the lawsuit, the individual may choose to pursue the case alone, although the government must be kept apprised of the progress of the lawsuit, and may intervene later. Whether or not the federal government intervenes in the case, it will receive the majority of any recovery.

When an entity is determined to have violated the federal False Claims Act, it must pay three times the actual damages sustained by the government, plus mandatory civil penalties for each separate false claim and the government's attorneys' fees. Liability arises when an entity knowingly submits, or causes someone else to submit, a false claim for reimbursement to the federal government. The False Claims Act defines the term "knowingly" broadly, though simple negligence will not give rise to liability under the False Claims Act. Examples of the other actions which may lead to liability under the False Claims Act:

Failure to comply with the many technical billing requirements applicable to our Medicare and Medicaid business.

Failure to comply with the prohibition against billing for services ordered or supervised by a physician who is excluded from any federal healthcare program, or the prohibition against employing or contracting with any person or entity excluded from any federal healthcare program.

Failure to comply with the Medicare physician supervision requirements for the services we provide, or the Medicare documentation requirements concerning physician supervision.

The Fraud Enforcement and Recovery Act of 2009 expanded the scope of the False Claims Act by, among other things, broadening protections for whistleblowers and creating liability for knowingly retaining a government overpayment, acting in deliberate ignorance of a government overpayment or acting in reckless disregard of a government overpayment. The recently enacted healthcare reform bills in the form of the Patient Protection and Affordable Care Act, as amended by the Health Care and Education Reconciliation Act of 2010 (collectively, "PPACA") expanded on changes made by the 2009 Fraud Enforcement and Recovery Act with regard to such "reverse false claims." Under PPACA, the knowing failure to report and return an overpayment within 60 days of identifying the overpayment or by the date a corresponding cost report is due, whichever is later, constitutes a violation of the False Claims Act. HMCA and its clients have never been sued under the False Claims Act and believe they are in compliance with the law.

### Stark Law

Under the federal Self-Referral Law, also referred to as the "Stark Law", which is applicable to Medicare and Medicaid patients, and the self-referral laws of various States, certain health practitioners, including physicians, chiropractors and podiatrists, are prohibited from referring their patients for the provision of designated health services, including diagnostic imaging and physical therapy services, to any entity with which they or their immediate family members have a financial relationship, unless the referral fits within one of the specific exceptions in the statutes or regulations. The federal government has taken the position that a violation of the federal Stark Law is also a violation of the Federal False Claims Act. Statutory exceptions under the Stark Law include, among others, direct



physician services, in-office ancillary services rendered within a group practice, space and equipment rental and services rendered to enrollees of certain prepaid health plans. Some of these exceptions are also available under the State self-referral laws. HMCA believes that it and its clients are in compliance with these laws.

## FONAR CORPORATION AND SUBSIDIARIES

### Anti-kickback Regulation

We are subject to federal and state laws which govern financial and other arrangements between healthcare providers. These include the federal anti-kickback statute which, among other things, prohibits the knowing and willful solicitation, offer, payment or receipt of any remuneration, direct or indirect, in cash or in kind, in return for or to induce the referral of patients for items or services covered by Medicare, Medicaid and certain other governmental health programs. Under PPACA, knowledge of the anti-kickback statute or the specific intent to violate the law is not required. Violation of the anti-kickback statute may result in civil or criminal penalties and exclusion from the Medicare, Medicaid and other federal healthcare programs, and according to PPACA, now provides a basis for liability under the False Claims Act. In addition, it is possible that private parties may file “qui tam” actions based on claims resulting from relationships that violate the anti-kickback statute, seeking significant financial rewards. Many states have enacted similar statutes, which are not limited to items and services paid for under Medicare or a federally funded healthcare program.

Neither HMCA nor its clients engage in this practice.

In fiscal 2014, approximately 6.5% of the revenues of HMCA’s clients were attributable to Medicare and 0.25% were attributable to Medicaid. In fiscal 2013, approximately 7.6% of the revenues of HMCA’s clients were attributable to Medicare and 0.5% were attributable to Medicaid.

### Deficit Reduction Act (DRA)

On February 8, 2006, the President signed into law the DRA. Effective January 1, 2007, the DRA provides that Medicare reimbursement for the technical component for imaging services (excluding diagnostic and screening mammography) performed in freestanding facilities will be capped. Payment will be the lesser of the Medicare Physician Fee Schedule or the Hospital Outpatient Prospective Payment System (HOPS) rates. Implementation of these reimbursement reductions contained in the DRA has had an adverse effect on our business. In fiscal 2012, however, we were able to counter this effect by increasing our clients’ scan volumes through our vigorous marketing efforts.

The DRA also codified the reduction in reimbursement for multiple images on contiguous body parts previously announced by CMS, the agency responsible for administering the Medicare program. In November 2005, CMS announced that it would pay 100% of the technical component of the higher priced imaging procedure and 50% of the technical component of each additional imaging procedure for imaging procedures involving contiguous body parts within a family of codes when performed in the same session. CMS had indicated that it would phase in this 50% rate reduction over two years, so that the reduction was 25% for each additional imaging procedure in 2006 and another 25% reduction scheduled for 2007. However, for services furnished on or after July 1, 2010, the PPACA requires the full 50% reduction to be implemented. We believe that the impact of this final 25% reduction will not materially affect our operations.

### Health Insurance Portability and Accountability Act

Congress enacted the Health Insurance Portability and Accountability Act of 1996, or HIPAA, in part, to combat healthcare fraud and to protect the privacy and security of patients’ individually identifiable healthcare information. HIPAA, among other things, amends existing crimes and criminal penalties for Medicare fraud and enacts new federal healthcare fraud crimes, including actions affecting non-government healthcare benefit program by means of false or

fraudulent representations in connection with the delivery of healthcare services is subject to a fine or imprisonment, or potentially both. In addition, HIPAA authorizes the imposition of civil money penalties against entities that employ or enter into contracts with excluded Medicare or Medicaid program participants if such entities provide services to federal health program beneficiaries. A finding of liability under HIPAA could have a material adverse effect on our business, financial condition and results of operations.

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## FONAR CORPORATION AND SUBSIDIARIES

Further, HIPAA requires healthcare providers and their business associates to maintain the privacy and security of individually identifiable protected health information (“PHI”). HIPAA imposes federal standards for electronic transactions, for the security of electronic health information and for protecting the privacy of PHI. The Health Information Technology for Economic and Clinical Health Act of 2009 (“HITECH”), signed into law on February 17, 2009, dramatically expanded, among other things, (1) the scope of HIPAA to now apply directly to “business associates,” or independent contractors who receive or obtain PHI in connection with providing a service to a covered entity, (2) substantive security and privacy obligations, including new federal security breach notification requirements to affected individuals, DHHS and prominent media outlets, of certain breaches of unsecured PHI, (3) restrictions on marketing communications and a prohibition on covered entities or business associates from receiving remuneration in exchange for PHI, and (4) the civil and criminal penalties that may be imposed for HIPAA violations, increasing the annual cap in penalties from \$25,000 to \$1.5 million per occurrence.

In addition, many states have enacted comparable privacy and security statutes or regulations that, in some cases, are most stringent than HIPAA requirements. In those cases it may be necessary to modify our operations and procedures to comply with the more stringent state laws, which may entail significant and costly changes for us. We believe that we are in compliance with such state laws and regulations. However, if we fail to comply with applicable state laws and regulations, we could be subject to additional sanctions.

We believe that we are in compliance with the current HIPAA requirements, as amended by HITECH, and comparable state laws, but we anticipate that we may encounter certain costs associated with future compliance. Moreover, we cannot guarantee that enforcement agencies or courts will not make interpretations of the HIPAA standards that are inconsistent with ours, or the interpretations of our contracted radiology practices or their affiliated physicians. A finding of liability under the HIPAA standards may result in significant criminal and civil penalties. Noncompliance also may result in exclusion from participation in government programs, including Medicare and Medicaid. These actions could have a material adverse effect on our business, financial condition, and results of operations.

### Civil Money Penalty Law and Other Federal Statutes

The Civil Money Penalty, or CMP, law covers a variety of practices. It provides a means of administrative enforcement of the anti-kickback statute, and prohibits false claims, claims for medically unnecessary services, violations of Medicare participating provider or assignment agreements and other practices. The statute gives the Office of Inspector General of the HHS the power to seek substantial civil fines, exclusion and other sanctions against providers or others who violate the CMP prohibitions.

In addition, in 1996, Congress created a new federal crime: healthcare fraud and false statements relating to healthcare matters. The healthcare fraud statute prohibits knowingly and willfully executing a scheme to defraud any healthcare benefit program, including private payors. A violation of this statute is a felony and may result in fines, imprisonment or exclusion from government sponsored programs such as the Medicare and Medicaid programs.

### Certificates of Need

Some states require hospitals and certain other healthcare facilities and providers to obtain a certificate of need, or CON, or similar regulatory approval prior to establishing certain healthcare operations or services, incurring certain capital projects and/or the acquisition of major medical equipment including MRI and PET/CT systems. We are not operating in any such states.



## FONAR CORPORATION AND SUBSIDIARIES

### Patient Protection and Affordable Care Act

On March 23, 2010, President Obama signed into law healthcare reform legislation in the form of PPACA. The implementation of this law will likely have a profound impact on the healthcare industry. Most of the provisions of PPACA are being phased in over time and can be conceptualized as a broad framework not only to provide health insurance coverage to millions of Americans, but to fundamentally change the delivery of care by bringing together elements of health information technology, evidence-based medicine, chronic disease management, medical “homes,” care collaboration and shared financial risk in a way that will accelerate industry adoption and change. There are also many provisions addressing cost containment, reductions of Medicare and other payments and heightened compliance requirements and additional penalties, which will create further challenges for providers. We are unable to predict the full impact of PPACA at this time due to the law’s complexity and current lack of implementing regulations or interpretive guidance. Moving forward, we believe that the federal government will likely have greater involvement in the healthcare industry than in prior years.

### State Regulation

In addition to the federal self-referral law and federal Anti-kickback statute, many States, including those in which HMCA and its clients operate, have their own versions of self-referral and anti-kickback laws. These laws are not limited in their applicability, as are the federal laws, to specific programs. HMCA believes that it and its clients are in compliance with these laws.

Various States prohibit business corporations from practicing medicine. Various States, including New York, also prohibit the sharing of professional fees or fee splitting. Consequently, in New York HMCA leases space and equipment to clients and provides clients with a range of non-medical administrative and managerial services for agreed upon fees. Under Florida law a business entity can bill patients and third party payors directly, and at four of the seven facilities in Florida, HMCA’s subsidiaries do so.

HMCA’s clients generate revenue from patients covered by no-fault insurance and workers' compensation programs. For the fiscal year ended June 30, 2014 approximately 43.4% of our clients’ receipts were from patients covered by no-fault insurance and approximately 6.3% of our client’s receipts were from patients covered by workers’ compensation programs. For the fiscal year ended June 30, 2013, approximately 37.0% of HMCA’s clients’ receipts were from patients covered by no-fault insurance and approximately 3.8% of HMCA’s clients’ receipts were from patients covered by workers’ compensation programs. (The foregoing numbers do not include payments from third party administrators). In the event that changes in these laws alter the fee structures or methods of providing service, or impose additional or different requirements, HMCA could be required to modify its business practices and services in ways that could be more costly to HMCA or in ways that decrease the revenues which HMCA receives from its clients.

### Compliance Program

We maintain a program to monitor compliance with federal and state laws and regulations applicable to the healthcare entities. We have a compliance officer who is charged with implementing and supervising our compliance program, which includes the adoption of (i) Standards of Conduct for our employees and affiliates and (ii) a process that specifies how employees, affiliates and others may report regulatory or ethical concerns to our compliance officer. We

believe that our compliance program meets the relevant standards provided by the Office of Inspector General of the Department of Health and Human Services.

An important part of our compliance program consists of conducting periodic audits of various aspects of our operations and that of the contracted radiology practices. We also conduct mandatory educational programs designed to familiarize our employees with the regulatory requirements and specific elements of our compliance program.

HMCA believes that it and its clients are in compliance with applicable Federal, State and local laws. HMCA does not believe that such laws will have any adverse material effect on its business.

## FONAR CORPORATION AND SUBSIDIARIES

### EMPLOYEES

Fonar and its subsidiaries, HMCA and HDM had approximately 430 employees as of August 1, 2014. This total number included 15 in production, 30 in customer support, 8 in research and development, 4 in information technology, 48 in marketing and sales, 42 transcriptionists, 30 technologists, 39 in billing and collections, and 214 in various administrative positions. Approximately 231 employees employed at the MRI facilities managed or owned by HMCA and HDM, primarily in administrative positions.

### ITEM 2. PROPERTIES

Fonar currently leases approximately 78,000 square feet of office and plant space at its principal offices in Melville, New York. The term of the lease runs through 2016. Management believes that the premises will be adequate for its current needs. HMCA and HD already have consolidated their headquarters with those of Fonar as part of the Company's cost cutting measures. HMCA and HD maintain leased office premises for their clients at the clients' sites under leases having various terms.

### ITEM 3. LEGAL PROCEEDINGS

Matt Malek Madison v. Fonar Corporation, United States District Court, Northern District of California, was commenced by plaintiff on August 27, 2007 to recover a down payment for a scanner in the amount of \$300,000, with interest. The plaintiff sought costs of suit and attorney's fees as well. Fonar answered the complaint and sued the plaintiff for breach of contract in the amount of \$450,000. Although down payments are usually expressly non-refundable in Fonar's quotations and agreements, in this case, the quotation contemplated the sale of four scanners, and provided that the deposit would be refundable with interest, if the customer were unable to find suitable locations in the San Francisco Bay area. The issue was whether the customer made a good faith effort to find locations; Fonar's position was that the customer did not. The case went to trial before a judge; the parties submitted post-trial briefs, and judgment was awarded to the plaintiff. Fonar appealed the trial court's decision, but on January 31, 2012, the U.S. Court of Appeals for the 9<sup>th</sup> Circuit affirmed the lower court's decision awarding the plaintiff the \$300,000 deposit with prejudgment interest from July 1, 2006. Fonar sought to have the Court of Appeals reconsider the decision en banc, (by all or a larger number of the judges on the Circuit Court of Appeals), but this was not granted. Although the case has been concluded, the plaintiff has not taken any steps to collect the judgment.

ITEM 4. MINE SAFETY DISCLOSURES. Not Applicable

## PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS



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Our Common Stock is traded in the Nasdaq SmallCap market under the National Association of Securities Dealers Automated Quotation System, also referred to as "NASDAQ", under the symbol FONR. The following table sets forth the high and low trades reported in NASDAQ System for the periods shown.

| Fiscal Quarter   |      | High  | Low   |
|------------------|------|-------|-------|
| January - March  | 2012 | 2.89  | 1.68  |
| April - June     | 2012 | 6.8   | 2.68  |
| July - September | 2012 | 4.12  | 3.02  |
| January - March  | 2013 | 7.44  | 4.42  |
| April - June     | 2013 | 7.94  | 5.67  |
| July - September | 2013 | 6.7   | 5.12  |
| January - March  | 2014 | 27.95 | 16.2  |
| April - June     | 2014 | 18.7  | 11.28 |

## FONAR CORPORATION AND SUBSIDIARIES

On September 2, 2014, we had approximately 1,813 stockholders of record of our Common Stock, 11 stockholders of record of our Class B Common Stock, 3 stockholders of record of our Class C Common Stock and 1,807 stockholders of record of our Class A Non-voting Preferred Stock.

At the present time, the only class of our securities for which there is a market is the Common Stock.

We paid cash dividends in fiscal 1998 and the first three quarters of fiscal 1999 on monies we received from the enforcement of our patents. Except for these dividends, we have not paid any cash dividends. Except for these dividends, we expect that we will retain earnings to finance the development and expansion of our business for the foreseeable future.

## ITEM 6. SELECTED FINANCIAL DATA.

The following selected consolidated financial data has been extracted from our consolidated financial statements for the five years ended June 30, 2014. This consolidated selected financial data should be read in conjunction with our consolidated financial statements and the related notes included in Item 8 of this form.

As of and For the Periods Ended June 30,

|   | 2014         | 2013         | 2012         | 2011          | 2010             |
|---|--------------|--------------|--------------|---------------|------------------|
| <b>STATEMENT OF OPERATIONS</b>                        |              |              |              |               |                  |
| Revenues  | \$68,505,477 | \$49,141,814 | \$39,444,419 | \$ 33,136,395 | \$ 31,815,555    |
| Cost of revenues                                      | \$37,247,449 | \$26,121,365 | \$21,195,680 | \$ 18,479,550 | \$ 18,620,220    |
| Research and Development Expenses                     | \$1,760,821  | \$1,438,560  | \$1,242,656  | \$ 1,440,032  | \$ 2,458,342     |
| Net Income (Loss)                                     | \$13,396,769 | \$10,256,362 | \$6,875,073  | \$ 3,309,019  | (\$3,012,742.00) |
| Basic Net Income (Loss) per common share              | \$1.62       | \$1.37       | \$0.93       | \$ 0.56       | (\$0.61 )        |
| Diluted Net Income (Loss) per common share            | \$1.58       | \$1.34       | \$0.91       | \$ 0.55       | (\$0.61 )        |
| Basic Weighted average number of shares outstanding   | 6,009,822    | 5,933,318    | 5,778,695    | 5,264,795     | 4,932,044        |
| Diluted Weighted average number of shares outstanding | 6,137,326    | 6,060,822    | 5,906,199    | 5,392,299     | 4,932,044        |
| <b>BALANCE SHEET DATA</b>                             |              |              |              |               |                  |
| Working capital (deficiency)                          | \$21,624,952 | \$16,748,144 | \$4,805,347  | (\$575,628 )  | (\$10,025,577 )  |
| Total Assets  | \$76,789,843 | \$73,150,650 | \$33,635,002 | \$ 31,580,674 | \$ 21,628,845    |
| Long-term debt and obligations under capital leases   | \$8,481,830  | \$12,887,005 | \$777,274    | \$ 1,746,286  | \$ 1,638,963     |
| Stock holder's (deficiency) equity                    | \$45,906,592 | \$37,799,276 | \$11,101,065 | \$ 5,865,814  | (\$5,775,966 )   |

## FONAR CORPORATION AND SUBSIDIARIES

### ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION.

#### INTRODUCTION.

Fonar was formed in 1978 to engage in the business of designing, manufacturing and selling MRI scanners. In 1997, we formed a wholly-owned subsidiary, Health Management Corporation of America, also referred to as HMCA and formerly known as U.S. Health Management Corporation, in order to expand into the physician and diagnostic management services business. HMCA currently provides its services exclusively to diagnostic imaging facilities.

Fonar's principal MRI product is its Stand-Up®/Upright® MRI scanner. The Stand-Up® MRI allows patients to be scanned for the first time under weight-bearing conditions. The Stand-Up® MRI is the only MRI capable of producing images in the weight-bearing state.

At 0.6 Tesla field strength, the Upright® MRI and Fonar 360™ magnets are among the highest field open MRI scanners in the industry, offering non-claustrophobic MRI together with high-field image quality. Fonar's open MRI scanners were the first high field strength open MRI scanners in the industry.

HMCA commenced operations in July, 1997 and generates revenues from providing comprehensive management services, including development, administration, accounting, billing and collection services, together with office space, medical equipment, supplies and non-medical personnel to its clients. Revenues are in the form of fees which are earned under contracts with HMCA's clients except for three Florida subsidiaries which bill and collect fees from patients, insurers and other third party payors directly.

For the fiscal years ended June 30, 2014 and June 30, 2013, 11.1% and 23.0%, respectively, of total revenues were derived from contracts with facilities owned by Dr. Raymond V. Damadian, the President of Fonar and HMCA, and principal stockholder of Fonar. The agreements with these MRI facilities are for one-year terms which renew automatically on an annual basis, unless terminated. The fees for these sites, which are located in Florida, are flat monthly fees.

#### Industry Updates

For services for which Medicare is billed directly, the sites are paid under the Medicare Physician Fee Schedule, which is updated on an annual basis. Under the Medicare statutory formula, payments under the Physician Fee Schedule would have decreased for the past several years if Congress failed to intervene.

Many private payors use the Medicare Physician Fee Schedule to determine their own reimbursement rates.

While Congress has repeatedly intervened to mitigate the negative reimbursement impact associated with the formula, there is no guarantee that Congress will continue to do so in the future. Moreover, the existing methodology may result in significant yearly fluctuations in the Medicare Physician Fee Schedule amounts, which may be unrelated to changes in the actual costs of providing physician services.

The 2013 Medicare Physician Fee Schedule expanded a reduction in reimbursement for multiple images on contiguous body parts to new services, namely diagnostic cardiovascular services and ophthalmology services. Medicare has a longstanding policy to reduce payment by 50% for the second and subsequent procedures furnished to

the same beneficiary by a single physician or physicians in the same group practice on the same day.

Critical Accounting Policies

Our discussion and analysis of financial condition and results of operations are based on our consolidated financial statements that were prepared in accordance with U.S. generally accepted accounting principles, or GAAP. Management makes estimates and assumptions when preparing financial statements. These estimates and assumptions affect various matters, including:

our reported amounts of assets and liabilities in our consolidated balance sheets at the dates of the financial statements

our disclosure of contingent assets and liabilities at the dates of the financial statements; and

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## FONAR CORPORATION AND SUBSIDIARIES

our reported amounts of net revenue and expenses in our consolidated statements of operations during the reporting periods

These estimates involve judgments with respect to numerous factors that are difficult to predict and are beyond management's control. As a result, actual amounts could differ materially from these estimates.

The Securities and Exchange Commission defines critical accounting estimates as those that are both most important to the portrayal of a company's financial condition and results of operations and require management's most difficult, subjective or complex judgment, often as a result of the need to make estimates about the effect of matters that are inherently uncertain and may change in subsequent periods. In the notes to our consolidated financial statements, we discuss our significant accounting policies.

We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our consolidated financial statements. We recognize revenue and related costs of revenue from sales contracts for our MRI scanners under the percentage-of-completion method. Under this method, we recognize revenue and related costs of revenue, as each sub-assembly is completed. Amounts received in advance of our commencement of production are recorded as customer advances.

We evaluate the realizability of the net deferred tax assets and assess the valuation allowance periodically. If future taxable income or other factors are not consistent with our expectations, an adjustment to our allowance for net deferred tax assets may be required. For net deferred tax assets we consider estimates of future taxable income, including tax planning strategies, in determining whether our net deferred tax assets are more likely than not to be realized.

In 2013 we recorded a valuation allowance resulting in a deferred tax asset of \$2,473,892. As of June 30, 2012, we had recorded a valuation allowance which reduced our deferred tax assets to equal our deferred tax liability. At June 30, 2014, the deferred tax asset was \$5,156,297.

We depreciate our long-lived assets over their estimated economic useful lives with the exception of leasehold improvements where we use the shorter of the assets useful lives or the lease term of the facility for which these assets are associated.

The Company provides for medical receivables that could become uncollectible by establishing an allowance for doubtful accounts in order to adjust medical receivables to estimated net realizable value. In evaluating the collectability of medical receivables, the Company considers a number of factors, including the age of the account, historical collection experiences, payor type, current economic conditions and other relevant factors. There are various factors that impact collection trends, such as payor mix, changes in the economy, increase burden on copayments to be made by patients with insurance and business practices related to collection efforts. These factors continuously change and can have an impact on collection trends and the estimation process.

We amortize our intangible assets, including patents, purchased management agreements and capitalized software development costs, over the shorter of the contractual/legal life or the estimated economic life. Our amortization life for patents and capitalized software development costs is 15 to 17 years and 5 years, respectively. Our amortization of the non-competition agreements entered into with certain individuals in connection with the HDM transaction are depreciated over seven years, and customer relationships are amortized over 20 years.

Goodwill is recorded as a result of business combinations. Management evaluates goodwill, at a minimum, on an annual basis and whenever events and changes in circumstances suggest that the carrying amount may not be recoverable. Impairment of goodwill is tested by comparing the reporting unit's carrying amount, including goodwill, to the fair value of the reporting unit. The fair value of a reporting unit is estimated using a combination of the income or discounted cash flows approach and the market approach, which uses comparable market data. If the carrying amount of the reporting unit exceeds its fair value, goodwill is considered impaired and a second step is performed to measure the amount of impairment loss, if any. Based on our test for goodwill impairment, we noted no impairment related to goodwill. However, if estimates or the related assumptions change in the future, we may be required to record impairment charges to reduce the carrying amount of goodwill.

## FONAR CORPORATION AND SUBSIDIARIES

We periodically assess the recoverability of long-lived assets, including property and equipment, intangibles and management agreements, when there are indications of potential impairment, based on estimates of undiscounted future cash flows. The amount of impairment is calculated by comparing anticipated discounted future cash flows with the carrying value of the related asset. In performing this analysis, management considers such factors as current results, trends, and future prospects, in addition to other economic factors.

### RESULTS OF OPERATIONS. FISCAL 2014 COMPARED TO FISCAL 2013

In fiscal 2014, we recognized net income of \$13.4 million on revenues of \$68.5 million, as compared to net income of \$10.3 million on revenues of \$49.1 million for fiscal 2013. This represents an increase in revenues of 39.5%. The increased revenue for fiscal 2014 resulted primarily from the inclusion of the revenues of HDM for a full fiscal year. Unrelated party management fees increased by 62%. Total costs and expenses increased by 35%. Our consolidated operating results improved by \$4.8 million to an operating income of \$12.3 million for fiscal 2014 as compared to an operating income of \$7.5 million for fiscal 2013.

#### Discussion of Operating Results of Medical Equipment Segment

##### Fiscal 2014 Compared to Fiscal 2013

Revenues attributable to our medical equipment segment decreased by 18.9% to \$12.1 million in fiscal 2014 from \$14.9 million in fiscal 2013, with product sales revenues decreasing by 52.3% from \$3.9 million in fiscal 2013 to \$1.9 million in fiscal 2014. Service revenue decreased from \$11.0 million in fiscal 2013 to \$10.2 million in fiscal 2014.

The Upright® MRI is unique in that it permits MRI scans to be performed on patients upright in the weight-bearing state and in multiple positions that correlate with symptoms.

Product sales to unrelated parties decreased by 52.3% in fiscal 2014 from \$3.9 million in fiscal 2013 to \$1.9 million in fiscal 2014. There were no product sales to related parties in fiscal 2014 or 2013.

We believe that one of our principal challenges in achieving greater market penetration is attributable to the better name recognition and larger sales forces of our larger competitors such as General Electric, Siemens, Hitachi, Philips and Toshiba and the ability of some of our competitors to offer attractive financing terms through affiliates, such as G.E. Capital. Nevertheless, no other competitor offers a whole body weight-bearing multi-position MRI scanner as the FONAR Upright® MRI.

The operating results for the medical equipment segment increased from income of \$140,000 in fiscal 2013 to income of \$469,000 in fiscal 2014. This increase is attributable most significantly to the fact that costs decreased by a greater amount than the revenues decreased.

We recognized revenues of \$957,000 from the sale of our Upright® MRI scanners in fiscal 2014, while in fiscal 2013, we recognized revenues of \$3.2 million from the sale of Upright® MRI scanners.

Research and development expenses, increased by 22.4% to \$1.8 million in fiscal 2014 as compared to \$1.4 million in fiscal 2013. Our expenses for fiscal 2014 represented continued research and development of Fonar's scanners, Fonar's new hardware and software product, Sympulse® and new surface coils to be used with the Upright® MRI scanner.

Discussion of Operating Results of Physician and Diagnostic Services Management Segment.

Fiscal 2014 Compared to Fiscal 2013

Revenues attributable to the Company's physician and diagnostic services management segment, HMCA, increased by 65.2% to \$56.5 million in fiscal 2014 from \$34.3 million in fiscal 2013. The increase in revenues was primarily due to the 14 additional scanning facilities acquired in the HDM transaction, which resulted in the recognition of \$35.9 million in revenues from HDM, including \$13.9 million of patient fees (net of contractual allowances and discounts less provision for bad debts) from patient and third party payors recognized by four of the facilities in Florida.



## FONAR CORPORATION AND SUBSIDIARIES

Cost of revenues as a percentage of the related revenues for our physician and diagnostic services management segment increased from \$19.2 million or 39.2% of related revenues for the year ended June 30, 2013 to \$33.7 million, or 59.6% of related revenue for the year ended June 30, 2014.

Operating results of this segment increased from operating income of \$7.4 million in fiscal 2013 to operating income of \$11.8 million in fiscal 2014. We believe that the 14 additional facilities managed by HDM and our efforts to expand and improve the operation of our physician and diagnostic services management segment are directly responsible for the profitability of this segment and our company as a whole.

### Discussion of Certain Consolidated Results of Operations

#### Fiscal 2014 Compared to Fiscal 2013

Interest and investment income decreased in 2014 compared to 2013. We recognized interest income of \$238,928 in 2014 as compared to \$217,598 in fiscal 2013, representing an increase of 9.8%.

Interest expense of \$884,541 was recognized in fiscal 2014, as compared to \$500,362 in fiscal 2013, representing an increase of 76.8%.

While revenue increased by 39.4%, selling, general and administrative expenses increased by 23.1% to \$15.4 million in fiscal 2014 from \$12.5 million in fiscal 2013.

The compensatory element of stock issuances decreased from approximately \$415,021 in fiscal 2013 to \$223,000 in fiscal 2014, reflecting a decrease in Fonar's use of its stock bonus plans to pay employees and others.

The higher provision for bad debts of \$1.8 million in fiscal 2014 as compared to \$1.5 million in fiscal 2013, reflected an increase in reserves for certain indebtedness in fiscal 2014 by our physician and diagnostic services management segment. In addition in fiscal 2014, the Company recorded a provision for bad debts for patient fee revenue of \$10.3 million for the four MRI facilities in Florida which bill patients and third party payors directly. The three Florida sites managed by HMCA jointly and severally guaranteed the payment of their management fees to HMCA, further securing HMCA's management fee receivables.

Revenue from service and repair fees decreased from \$11.0 million in fiscal 2013 to \$10.2 million in fiscal 2014.

Continuing our tradition as the originator of MRI, we remain committed to maintaining our position as the leading innovator of the industry through investing in research and development. In fiscal 2014 we continued our investment in the development of our new MRI scanners, together with software and upgrades, with an investment of \$1,760,821 in research and development, none of which was capitalized, as compared to \$1,438,560, none of which was capitalized, in fiscal 2013. The research and development expenditures were approximately 14.6% of revenues attributable to our medical equipment segment and 2.6% of total revenues in 2014, and 9.7% of medical equipment segment revenues and 2.9% of total revenues in fiscal 2013. This represented a 22.4% increase in research and development expenditures in fiscal 2014 as compared to fiscal 2013.

The physician and diagnostic services management segment, HMCA, revenues increased, from \$34.3 million in fiscal 2013 to \$56.5 million in fiscal 2014. This is primarily attributable to increased revenue resulting from the HDM acquisition for a full fiscal year.

We have been taking steps to improve HMCA revenues by our marketing efforts, which focus on the unique capability of our Upright® MRI scanners to scan patients in different positions. We have also been increasing the number of health insurance plans in which our clients participate.

Marketing expenditures may increase, as the Company continues its efforts to promote sales.

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## FONAR CORPORATION AND SUBSIDIARIES

Our management fees are dependent on collection by our clients of fees from reimbursements from Medicare, Medicaid, private insurance, no fault and workers' compensation carriers, self-pay and other third-party payors. The health care industry is experiencing the effects of the federal and state governments' trend toward cost containment, as governments and other third-party payors seek to impose lower reimbursement and utilization rates and negotiate reduced payment schedules with providers. The cost-containment measures, consolidated with the increasing influence of managed-care payors and competition for patients, have resulted in reduced rates of reimbursement for services provided by our clients from time to time. Our future revenues and results of operations may be adversely impacted by future reductions in reimbursement rates.

Certain third-party payors have proposed and implemented changes in the methods and rates of reimbursement that have had the effect of substantially decreasing reimbursement for diagnostic imaging services that HMCA's clients provide. To the extent reimbursement from third-party payors is reduced, it will likely have an adverse impact on the rates they pay us, as they would need to reduce the management fees they pay HMCA to offset such decreased reimbursement rates. Furthermore, many commercial health care insurance arrangements are changing, so that individuals bear greater financial responsibility through high deductible plans, co-insurance and higher co-payments, which may result in patients delaying or foregoing medical procedures. We expect that any further changes to the rates or methods of reimbursement for services, which reduce the reimbursement per scan of our clients may partially offset the increases in scan volume we are working to achieve for our clients, and indirectly will result in a decline in our revenues.

On March 23, 2010, President Obama signed into law healthcare reform legislation in the form of the Patient Protection and Affordable Care Act, or PPACA. The implementation of this law will likely have a profound impact on the healthcare industry, most of which will go into effect in fiscal 2014 and thereafter. Healthcare cost containment, reductions of Medicare and other payments, and increased regulation will present additional challenges for healthcare providers. We are unable to predict the full impact of PPACA at this time, but anticipate the possibility that it may reduce the profitability of both our medical equipment segment and physician and diagnostic services management segment. In addition there are also political uncertainties which may result in the repeal or modification of PPACA or the adoption of alternative medical cost containment and insurance requirements.

In addition, the use of radiology benefit managers, or RBM's has increased in recent years. It is common practice for health insurance carriers to contract with RBMs to manage utilization of diagnostic imaging procedures for their insureds. In many cases, this leads to lower utilization of imaging procedures based on a determination of medical necessity. The efficacy of RBMs is still a high controversial topic. We cannot predict whether the healthcare legislation or the use of RBMs will negatively impact our business, but it is possible that our financial position and results of operations could be negatively affected.

## LIQUIDITY AND CAPITAL RESOURCES

Cash, cash equivalents and marketable securities increased by 26.4% from \$7.9 million at June 30, 2013 to \$10.0 million at June 30, 2014.

Cash provided by operating activities for fiscal 2014 approximated \$13.4 million. Cash provided by operating activities was attributable to the net income of \$13.4 million, depreciation and amortization of \$3.8 million, which was offset by the deferred income tax benefit of \$2.7 million and the increase in accounts, medical and management fee

receivables of \$4.0 million.

Cash used in investing activities for fiscal 2014 approximated \$835,000. The use of cash from investing activities was attributable to purchases of property and equipment of \$621,000, and costs of patents of \$214,000.

Cash used by financing activities for fiscal 2014 approximated \$10.4 million. The principal uses of cash in financing activities included the repayment of loans and capital lease obligations of \$4.4 million, distributions to non-controlling interests of \$5.0 million and a redemption of non-controlling interests of \$1.1 million.

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## FONAR CORPORATION AND SUBSIDIARIES

Total liabilities decreased by 13.3% during fiscal 2014, from approximately \$35.4 million at June 30, 2013 to approximately \$30.9 million at June 30, 2014.

As at June 30, 2014, our obligations included approximately \$5.0 million in various state sales taxes, inclusive of penalties and interest. The Company will attempt to obtain a reduction of penalties in negotiating final settlements.

At June 30, 2014, we had working capital of approximately \$21.6 million as compared to working capital of \$16.7 million at June 30, 2013, and stockholders' equity of \$45.9 million at June 30, 2014 as compared to stockholders' equity of \$37.8 million at June 30, 2013. For the year ended June 30, 2014, we realized a net income of \$13.4 million.

Our principal sources of liquidity has been derived from investments, revenues and the proceeds of loans obtained in connection with the HDM acquisition.

Our business plan includes a program for manufacturing and selling our Upright® MRI scanners. In addition, we are enhancing our revenue by participating in the physician and diagnostic services management business through our subsidiary, HMCA and have upgraded the facilities which it manages, most significantly by the replacement of the original MRI scanners with new Upright® MRI scanners. Presently, 23 of the 24 MRI facilities managed by HMCA, are equipped with Upright® MRI scanners. We have also intensified our marketing activities through the hiring of additional marketers for HMCA's clients.

Our business plan also calls for a continuing emphasis on providing our customers with enhanced equipment service and maintenance capabilities and delivering state-of-the-art, innovative and high quality equipment upgrades at competitive prices. Fees for on-going service and maintenance from our installed base of scanners were \$11.0 million for the year ended June 30, 2013 and \$10.2 million for the year ended June 30, 2014.

In order to promote profitability and to reduce demands on our cash and other liquid reserves, we maintain an aggressive program of cost cutting. These measures included consolidating HMCA's office space with Fonar's office space, reductions in the size of our workforce, compensation and benefits, as well as across the board reduction of expenses. The cost reductions are intended to enable us to withstand periods of low volumes of MRI scanner sales, by keeping expenditures at levels which can be supported by service revenues and HMCA and HDM revenues.

Current economic credit conditions have contributed to a slower than optimal business environment. Given liquidity and credit constraints in the markets, our business may suffer, should the credit markets not improve in the near future. The direct impact of these conditions is not fully known.

Revenues from HMCA and HDM have been the principal reason for our profitability, and we have so far been able to maintain and increase such revenues by increasing the number of scans being performed by the sites we manage and those we own, notwithstanding reductions in reimbursement rates from third party payors. The likelihood and effect of any subsequent reductions is not fully known.

Capital expenditures for fiscal 2014 approximated \$835,000. Capitalized patent costs were approximately \$214,000. Purchases of property and equipment were approximately \$621,000.

Fonar has not committed to making capital expenditures in the 2015 fiscal year.

The Company believes that its business plan has been responsible for the past two consecutive fiscal years of profitability (fiscal 2014 and fiscal 2013) and that its capital resources will be adequate to support operations at current levels through June 30, 2015.

#### ITEM 7A. QUALITATIVE AND QUANTITATIVE DISCLOSURES ABOUT MARKET RISK

The Company does not have any investments in marketable securities, foreign currencies, mutual funds, certificates of deposit or other fixed rate instruments. All of our funds are in cash accounts or money market accounts which are liquid.

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

See Note 10 to the consolidated Financial Statements for information on long-term debt.

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FONAR CORPORATION AND SUBSIDIARIES

Item 8

FINANCIAL STATEMENTS

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Audit Committee of the  
Board of Directors and Stockholders of  
FONAR Corporation and Subsidiaries

We have audited the accompanying consolidated balance sheets of FONAR Corporation and Subsidiaries (the “Company”) as of June 30, 2014 and 2013, and the related consolidated statements of income, stockholders’ equity and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of FONAR Corporation and Subsidiaries as of June 30, 2014 and 2013, and the consolidated results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), FONAR Corporation and Subsidiaries internal control over financial reporting as of June 30, 2014, based on the criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in 1992 and our report dated September 29, 2014 expressed an adverse opinion on the effectiveness of the Company’s internal control over financial reporting because of the existence of material weaknesses.

Very truly yours,

/s/ Marcum LLP

Marcum LLP

New York, New York

September 29, 2014

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## FONAR CORPORATION AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEETS

ASSETS

|  | June 30,<br>2014 | 2013         |
|--|------------------|--------------|
| Current Assets:  |                  |              |
| Cash and cash equivalents  | \$9,951,736      | \$7,870,727  |
| Accounts receivable – net of allowances for doubtful accounts of \$257,362 at June 30, 2014 and 2013   | 4,450,125        | 4,443,595    |
| Medical receivables –net of allowances for doubtful accounts of \$12,917,751 and \$2,584,669 at June 30, 2014 and 2013, respectively                   | 8,807,856        | 8,126,476    |
| Management and other fees receivable – net of allowances for doubtful accounts of \$10,901,619 and \$9,095,320 at June 30, 2014 and 2013, respectively | 11,970,388       | 11,465,913   |
| Management and other fees receivable – related medical practices – net of allowances for doubtful accounts of \$403,047 at June 30, 2014 and 2013      | 3,426,982        | 2,381,664    |
| Costs and estimated earnings in excess of billings on uncompleted contracts  | 759,809          | 445,742      |
| Inventories  | 2,443,536        | 2,077,088    |
| Prepaid expenses and other current assets  | 1,011,358        | 1,054,551    |
| Total Current Assets   | 42,821,790       | 37,865,756   |
| Deferred Income Tax Asset  | 5,740,287        | 2,935,750    |
| Property and Equipment – Net   | 15,029,729       | 17,524,494   |
| Goodwill   | 1,767,098        | 1,767,098    |
| Other Intangible Assets – Net  | 10,508,843       | 11,904,248   |
| Other Assets   | 922,096          | 1,153,304    |
| Total Assets   | \$76,789,843     | \$73,150,650 |

See accompanying notes to consolidated financial statements.



## FONAR CORPORATION AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEETS

LIABILITIES

|   | June 30,<br>2014 | 2013        |
|---|------------------|-------------|
| Current Liabilities:  |                  |             |
| Current portion of long-term debt and capital leases                        | \$2,890,816      | \$2,885,769 |
| Accounts payable  | 2,481,997        | 2,752,479   |
| Other current liabilities   | 9,024,033        | 8,494,361   |
| Unearned revenue on service contracts                                       | 4,730,962        | 4,965,415   |
| Customer deposits   | 1,926,813        | 1,857,870   |
| Billings in excess of costs and estimated earnings on uncompleted contracts | 142,217          | 142,217     |
| Income tax payable  | —                | 19,501      |
| Total Current Liabilities   | 21,196,838       | 21,117,612  |
| Long-Term Liabilities:  |                  |             |
| Deferred Income Tax Liability   | 583,990          | 461,858     |
| Due to Related Medical Practices  | 234,581          | 230,626     |
| Long-Term Debt and Capital Leases, Less Current Portion                     | 8,481,830        | 12,887,005  |
| Other Liabilities   | 386,012          | 654,273     |
| Total Long-Term Liabilities   | 9,686,413        | 14,233,762  |
| Total Liabilities   | 30,883,251       | 35,351,374  |

## Commitments, Contingencies and Other Matters

See accompanying notes to consolidated financial statements.



## FONAR CORPORATION AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEETS

STOCKHOLDERS' EQUITY

|  | June 30,<br>2014 | 2013          |
|--|------------------|---------------|
| Stockholders' Equity:  |                  |               |
| Class A non-voting preferred stock \$.0001 par value; 453,000 shares authorized at June 30, 2014 and 2013, 313,438 issued and outstanding at June 30, 2014 and 2013  | \$31             | \$31          |
| Preferred stock \$.001 par value; 567,000 shares authorized at June 30, 2014 and 2013, issued and outstanding – none   | —                | —             |
| Common stock \$.0001 par value; 8,500,000 shares authorized at June 30, 2014 and 2013, 6,057,483 and 5,980,775 issued at June 30, 2014 and 2013, respectively; 6,045,840 and 5,969,132 outstanding at June 30, 2014 and 2013, respectively | 606              | 598           |
| Class B common stock (10 votes per share) \$.0001 par value; 227,000 shares authorized at June 30, 2014 and 2013, 146 issued and outstanding at June 30, 2014 and 2013   | —                | —             |
| Class C common stock (25 votes per share) \$.0001 par value; 567,000 shares authorized at June 30, 2014 and 2013, 382,513 issued and outstanding at June 30, 2014 and 2013   | 38               | 38            |
| Paid-in capital in excess of par value   | 175,284,437      | 174,499,020   |
| Accumulated deficit  | (149,259,286)    | (159,655,416) |
| Notes receivable from employee stockholders  | (38,828 )        | (54,820 )     |
| Treasury stock, at cost – 11,643 shares of common stock at June 30, 2014 and 2013  | (675,390 )       | (675,390 )    |
| Total Fonar Corporation's Stockholders' Equity   | 25,311,608       | 14,114,061    |
| Noncontrolling interests   | 20,594,984       | 23,685,215    |
| Total Stockholders' Equity   | 45,906,592       | 37,799,276    |
| Total Liabilities and Stockholders' Equity   | \$76,789,843     | \$73,150,650  |

See accompanying notes to consolidated financial statements.





## FONAR CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF INCOME

|   | For the Years<br>Ended June 30, |              |
|---|---------------------------------|--------------|
|   | 2014                            | 2013         |
| Revenues  |                                 |              |
| Product sales – net   | \$1,877,932                     | \$3,939,140  |
| Service and repair fees – net   | 10,082,631                      | 10,841,935   |
| Service and repair fees – related parties – net   | 110,000                         | 110,000      |
| Patient fee revenue, net of contractual allowances and discounts  | 24,307,192                      | 7,481,865    |
| Provision for bad debts for patient fee   | (10,333,082)                    | (2,584,669)  |
| Management and other fees – net   | 34,839,969                      | 21,493,599   |
| Management and other fees – related medical practices – net   | 7,620,835                       | 7,859,944    |
| Total Revenues – Net  | 68,505,477                      | 49,141,814   |
| Costs and Expenses  |                                 |              |
| Costs related to product sales  | 1,067,120                       | 3,656,635    |
| Costs related to service and repair fees  | 2,496,985                       | 3,213,420    |
| Costs related to service and repair fees – related parties  | 27,242                          | 32,603       |
| Costs related to patient fee revenue  | 7,670,484                       | 2,704,758    |
| Costs related to management and other fees  | 20,851,065                      | 12,998,243   |
| Costs related to management and other fees – related medical practices  | 5,134,553                       | 3,515,706    |
| Research and development  | 1,760,821                       | 1,438,560    |
| Selling, general and administrative, inclusive of compensatory element of stock issuances of \$223,000 and \$415,021 for the years ended June 30, 2014 and 2013, respectively | 15,388,239                      | 12,501,621   |
| Provision for bad debts   | 1,806,299                       | 1,544,521    |
| Total Costs and Expenses  | 56,202,808                      | 41,606,067   |
| Income from Operations  | 12,302,669                      | 7,535,747    |
| Other Income and (Expenses):  |                                 |              |
| Interest expense  | (884,541 )                      | (500,362 )   |
| Investment income   | 238,928                         | 217,598      |
| Other (expense) income – net  | (608,599 )                      | 725,488      |
| Income before benefit (provision) for income taxes and noncontrolling interests   | 11,048,457                      | 7,978,471    |
| Benefit for Income Taxes  | 2,348,312                       | 2,277,891    |
| Net Income  | \$13,396,769                    | \$10,256,362 |
| Net Income – Noncontrolling Interests   | (3,000,639 )                    | (1,577,820 ) |
| Net Income – Controlling Interests  | \$10,396,130                    | \$8,678,542  |

See accompanying notes to consolidated financial statements.

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## FONAR CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF INCOME (Continued)

|  | For the Years<br>Ended June 30, |             |
|--|---------------------------------|-------------|
|  | 2014                            | 2013        |
| Net Income Available to Common Stockholders                          | \$9,720,030                     | \$8,107,367 |
| Net Income Available to Class A Non-Voting Preferred Stockholders    | \$503,911                       | \$425,708   |
| Net Income Available to Class C Common Stockholders                  | \$172,189                       | \$145,467   |
| Basic Net Income Per Common Share Available to Common Stockholders   | \$1.62                          | \$1.37      |
| Diluted Net Income Per Common Share Available to Common Stockholders | \$1.58                          | \$1.34      |
| Basic and Diluted Income Per Share – Common C                        | \$0.45                          | \$0.38      |
| Weighted Average Basic Shares Outstanding – Common Stockholder       | 6,009,822                       | 5,933,318   |
| Weighted Average Diluted Shares Outstanding – Common Stockholder     | 6,137,326                       | 6,060,822   |
| Weighted Average Basic Shares Outstanding – Class C Common           | 382,513                         | 382,513     |
| Weighted Average Diluted Shares Outstanding – Class C Common         | 382,513                         | 382,513     |

See accompanying notes to consolidated financial statements.



## FONAR CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

FOR THE YEAR ENDED JUNE 30, 2014 AND 2013

|   | Class A<br>Non-Voting<br>Preferred | Common<br>Shares | Stock<br>Amount | Class C<br>Common<br>Stock |
|---|------------------------------------|------------------|-----------------|----------------------------|
| Balance - June 30, 2012                                 | \$ 31                              | 5,901,262        | \$ 590          | \$ 38                      |
| Net income  | —                                  | —                | —               |                            |
| Stock issued to employees under stock bonus plans       | —                                  | 67,870           | 8               |                            |
| Payments on notes receivable from employee stockholders | —                                  | —                | —               |                            |
| Buyout of noncontrolling interests                      | —                                  | —                | —               |                            |
| Redemption of noncontrolling interests                  | —                                  | —                | —               |                            |
| Distributions to noncontrolling interests               | —                                  | —                | —               |                            |
| Proceeds from noncontrolling interest                   | —                                  | —                | —               |                            |
| Balance - June 30, 2013                                 | \$ 31                              | 5,969,132        | \$ 598          | \$ 38                      |
| Net income  | —                                  | —                | —               |                            |
| Stock issued to employees under stock bonus plans       | —                                  | 21,443           | 2               |                            |
| Issuance of stock for goods and services                | —                                  | 45,265           | 5               |                            |
| Payments on notes receivable from employee stockholders | —                                  | —                | —               |                            |
| Stock option exercised                                  | —                                  | 10,000           | 1               |                            |
| Redemption of noncontrolling interests                  | —                                  | —                | —               |                            |
| Distributions to noncontrolling interests               | —                                  | —                | —               | —                          |
| Balance - June 30, 2014                                 | \$ 31                              | 6,045,840        | \$ 606          | \$ 38                      |

See accompanying notes to consolidated financial statements.

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## FONAR CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

FOR THE YEAR ENDED JUNE 30, 2014 AND 2013

|   | Paid-in<br>Capital in<br>Excess of Par<br>Value | Treasury<br>Stock | Notes<br>Receivable<br>From<br>Employee<br>Stockholders |
|---|---|-------------------|---|
| Balance - June 30, 2012                                 | \$ 174,084,007                                  | (\$ 675,390)      | (\$ 70,813 )  |
| Net income  | —   | —                 | —   |
| Stock issued to employees under stock bonus plans       | 415,013   | —                 | —   |
| Payments on notes receivable from employee stockholders | —   | —                 | 15,993  |
| Buyout of noncontrolling interests                      | —   | —                 | —   |
| Redemption of noncontrolling interests                  | —   | —                 | —   |
| Distributions to noncontrolling interests               | —   | —                 | —   |
| Proceeds from noncontrolling interest                   | —   | —                 | —   |
| Balance - June 30, 2013                                 | \$ 174,499,020                                  | (\$ 675,390)      | (\$ 54,820 )  |
| Net income  | —   | —                 | —   |
| Stock issued to employees under stock bonus plans       | 222,998   | —                 | —   |
| Issuance of stock for goods and services                | 531,820   | —                 | —   |
| Payments on notes receivable from employee stockholders | —   | —                 | 15,992  |
| Stock option exercised                                  | 30,599  | —                 | —   |
| Redemption of noncontrolling interests                  | —   | —                 | —   |
| Distributions to noncontrolling interests               | —   | —                 | —   |
| Balance - June 30, 2014                                 | \$ 175,284,437                                  | (\$ 675,390)      | (\$ 38,828 )  |

See accompanying notes to consolidated financial statements.

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## FONAR CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

FOR THE YEARS ENDED JUNE 30, 2014 AND 2013

|   | Accumulated<br>Deficit | Noncontrolling<br>Interests | Total        |
|---|------------------------|-----------------------------|--------------|
| Balance - June 30, 2012                                 | (\$168,333,958)        | \$6,096,560                 | \$11,101,065 |
| Net income  | 8,678,542              | 1,577,820                   | 10,256,362   |
| Stock issued to employees under stock bonus plans       | —                      | —                           | 415,021      |
| Payments on notes receivable from employee stockholders | —                      | —                           | 15,993       |
| Buyout of noncontrolling interests                      | —                      | -564,315                    | -564,315     |
| Redemption of noncontrolling interests                  | —                      | -1,424,900                  | -1,424,900   |
| Distributions to noncontrolling interests               | —                      | -1,799,950                  | -1,799,950   |
| Proceeds from noncontrolling interest                   | —                      | 19,800,000                  | 19,800,000   |
| Balance - June 30, 2013                                 | (\$159,655,416)        | \$23,685,215                | \$37,799,276 |
| Net income  | 10,396,130             | 3,000,639                   | 13,396,769   |
| Stock issued to employees under stock bonus plans       | —                      | —                           | 223,000      |
| Issuance of stock for goods and services                | —                      | —                           | 531,825      |
| Payments on notes receivable from employee stockholders | —                      | —                           | 15,992       |
| Stock option exercised                                  | —                      | —                           | 30,600       |
| Redemption of noncontrolling interests                  | —                      | -1,125,100                  | -1,125,100   |
| Distributions to noncontrolling interests               | —                      | -4,965,770                  | -4,965,770   |
| Balance - June 30, 2014                                 | (\$149,259,286)        | \$20,594,984                | \$45,906,592 |

See accompanying notes to consolidated financial statements.

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## FONAR CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CASH FLOWS

|   | For the Years Ended June |                  |
|---|--------------------------|------------------|
|   | 30,                      |                  |
|   | 2014                     | 2013             |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>                                       |                          |                  |
| Net income  | \$ 13,396,769            | \$ 10,256,362    |
| Adjustments to reconcile net income to net cash provided by operating activities: |                          |                  |
| Depreciation and amortization   | 3,817,205                | 2,421,177        |
| Abandoned patents or software written off   | 250,523                  | 66,619           |
| Provision for bad debts   | 1,806,299                | 1,544,521        |
| Deferred income tax benefit   | (2,682,405 )             | (2,473,892 )     |
| Gain on sale of equipment   | —                        | (557,473 )       |
| Loss on disposition of equipment  | 657,350                  | —                |
| Gain on litigation settlement   | —                        | (755,500 )       |
| Impairment on management agreement  | —                        | 357,500          |
| Compensatory element of stock issuances   | 223,000                  | 415,021          |
| Stock issued for costs and expenses   | 531,825                  | —                |
| (Increase) decrease in operating assets, net:                                     |                          |                  |
| Accounts, medical and management fee receivables                                  | (4,044,002 )             | (3,717,440 )     |
| Notes receivable  | 95,623                   | 120,976          |
| Costs and estimated earnings in excess of billings on uncompleted contracts       | (314,067 )               | 682,854          |
| Inventories   | (366,448 )               | 117,861          |
| Prepaid expenses and other current assets   | 46,967                   | (698,284 )       |
| Other assets  | 131,811                  | (204,037 )       |
| Increase (decrease) in operating liabilities, net:                                |                          |                  |
| Accounts payable  | (270,482 )               | 628,033          |
| Other current liabilities   | 295,219                  | (414,402 )       |
| Customer advances   | 68,943                   | (567,914 )       |
| Billings in excess of costs and estimated earnings on uncompleted contracts       | —                        | 142,217          |
| Other liabilities   | (268,261 )               | 253,559          |
| Due to related medical practices  | 3,955                    | 1,885            |
| Income tax payable  | (19,501 )                | (80,499 )        |
| <b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>                                  | <b>13,360,323</b>        | <b>7,539,144</b> |

See accompanying notes to consolidated financial statements.

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## FONAR CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CASH FLOWS

|   | For the Years Ended June 30, |                     |
|---|------------------------------|---------------------|
|   | 2014                         | 2013                |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>                 |                              |                     |
| Purchases of property and equipment                         | \$(620,697 )                 | \$(1,135,382 )      |
| Cost of acquisition   | —                            | (40,000,000)        |
| Cost of patents   | (214,211 )                   | (159,907 )          |
| <b>NET CASH USED IN INVESTING ACTIVITIES</b>                | <b>(834,908 )</b>            | <b>(41,295,289)</b> |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>                 |                              |                     |
| Proceeds from debt  | —                            | 14,689,646          |
| Proceeds from sale of equipment                             | —                            | 700,000             |
| Repayment of borrowings and capital lease obligations       | (4,400,128 )                 | (1,821,617 )        |
| Repayment of notes receivable from employee stockholders    | 15,992                       | 15,993              |
| Stock option exercised                                      | 30,600                       | —                   |
| Distributions to noncontrolling interests                   | (4,965,770 )                 | (1,799,950 )        |
| Redemption of noncontrolling interests                      | (1,125,100 )                 | (1,424,900 )        |
| Buyout of noncontrolling interests                          | —                            | (564,315 )          |
| Proceeds from noncontrolling interest                       | —                            | 19,800,000          |
| <b>NET CASH (USED IN) PROVIDED BY FINANCING ACTIVITIES</b>  | <b>(10,444,406)</b>          | <b>29,594,857</b>   |
| <b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b> | <b>2,081,009</b>             | <b>(4,161,288 )</b> |
| <b>CASH AND CASH EQUIVALENTS – BEGINNING OF YEAR</b>        | <b>7,870,727</b>             | <b>12,032,015</b>   |
| <b>CASH AND CASH EQUIVALENTS – END OF YEAR</b>              | <b>\$9,951,736</b>           | <b>\$7,870,727</b>  |

See accompanying notes to consolidated financial statements.

FONAR CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2014 and 2013

NOTE 1 - DESCRIPTION OF BUSINESS AND LIQUIDITY AND CAPITAL RESOURCES

Description of Business

FONAR Corporation (the “Company” or “FONAR”) is a Delaware corporation, which was incorporated on July 17, 1978. FONAR is engaged in the research, development, production and marketing of medical scanning equipment, which uses principles of Magnetic Resonance Imaging (“MRI”) for the detection and diagnosis of human diseases. In addition to deriving revenues from the direct sale of MRI equipment, revenue is also generated from our installed-base of customers through our service and upgrade programs.

FONAR, through its wholly-owned subsidiary Health Management Corporation of America (“HMCA”) provides comprehensive management services to diagnostic imaging facilities. The services provided by the Company include development, administration, leasing of office space, facilities and medical equipment, provision of supplies, staffing and supervision of non-medical personnel, legal services, accounting, billing and collection and the development and implementation of practice growth and marketing strategies.

On March 5, 2013, the Company acquired a majority interest in a newly formed limited liability company, Health Diagnostics Management LLC (HDM), a business managing 12 Stand-Up MRI centers and 2 other scanning centers located in Florida and New York for a total cost of \$40 million. HDM has a perpetual existence. See Note 9.

During May 2011, HMCA contributed all of its assets together with its liabilities to a newly formed limited liability company, Imperial Management Services, LLC (“Imperial”), which has a perpetual existence. As of June 30, 2014, Imperial manages 11 diagnostic imaging facilities which are located in the states of New York and Florida.

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

The consolidated financial statements include the accounts of FONAR Corporation, its majority and wholly-owned subsidiaries and partnerships. The operating activities of subsidiaries are included in the accompanying consolidated statements from the date of acquisition. All significant intercompany accounts and transactions have been eliminated in consolidation.

Use of Estimates

The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities in the consolidated financial statements and accompanying notes. The most significant estimates relate to receivable allowances, intangible assets, income taxes and related tax asset valuation allowances, useful lives of property and equipment, contingencies, revenue recognition and the assessment of litigation. In addition, healthcare industry reforms and reimbursement practices will continue to impact the Company's operations and the determination of contractual and other allowance estimates. Actual results could differ from those estimates.

Inventories

Inventories consist of purchased parts, components and supplies, as well as work-in-process, and are stated at the lower of cost, determined on the first-in, first-out method, or market.

## FONAR CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2014 and 2013

## NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Property and Equipment

Property and equipment procured in the normal course of business is stated at cost. Property and equipment purchased in connection with an acquisition is stated at its estimated fair value, generally based on an appraisal. Property and equipment is being depreciated for financial accounting purposes using the straight-line method over their estimated useful lives. Leasehold improvements are being amortized over the shorter of the useful life or the remaining lease term. Upon retirement or other disposition of these assets, the cost and related accumulated depreciation of these assets are removed from the accounts and the resulting gains or losses are reflected in the results of operations. Expenditures for maintenance and repairs are charged to operations. Renewals and betterments are capitalized. Maintenance and repair expenses totaled approximately \$1,037,000 and \$598,000 for the years ended June 30, 2014 and 2013, respectively. The estimated useful lives in years are generally as follows:

|   |      |
|---|------|
| Diagnostic equipment under capital lease          | 2.5  |
| Diagnostic equipment                              | 5-13 |
| Research, development and demonstration equipment | 3-7  |
| Machinery and equipment                           | 2-7  |
| Furniture and fixtures                            | 3-9  |
| Leasehold improvements                            | 2-10 |
| Building  | 28   |

Long-Lived Assets

The Company periodically assesses the recoverability of long-lived assets, including property and equipment and intangibles, other than goodwill, when there are indications of potential impairment, based on estimates of undiscounted future cash flows. The amount of impairment is calculated by comparing anticipated discounted future cash flows with the carrying value of the related asset. In performing this analysis, management considers such factors as current results, trends, and future prospects, in addition to other economic factors.



Deferred Rent

Rent expense is recorded on the straight-line method based on the total minimum rent payments required over the term of the lease. The cumulative difference between the lease expense recorded under this method and the contractual lease payment terms is recorded as deferred rent.

FONAR CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2014 and 2013

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Other Intangible Assets

1) Capitalized Software Development Costs

Capitalization of software development costs begins upon the establishment of technological feasibility. Technological feasibility for the Company's computer software is generally based upon achievement of a detail program design free of high risk development issues and the completion of research and development on the product hardware in which it is to be used. The establishment of technological feasibility and the ongoing assessment of recoverability of capitalized computer software development costs require considerable judgment by management with respect to certain external factors, including, but not limited to, technological feasibility, anticipated future gross revenue, estimated economic life and changes in software and hardware technology. Prior to reaching technological feasibility those costs are expensed as incurred and included in research and development.

Amortization of capitalized software development costs commences when the related products become available for general release to customers. Amortization is provided on a product by product basis. The annual amortization is the greater of the amount computed using (a) the ratio that current gross revenue for a product bears to the total of current and anticipated future gross revenue for that product, or (b) the straight-line method over the remaining estimated economic life of the product.

The Company periodically performs reviews of the recoverability of such capitalized software development costs. At the time a determination is made that capitalized amounts are not recoverable, based on the estimated cash flows to be generated from the applicable software, any remaining capitalized amounts are written off.

2) Patents and Copyrights

Amortization is calculated on the straight-line basis over a period ranging from 15 to 17 years.

### 3) Management Agreement

The management agreement was being amortized on the straight line basis over the length of the agreement (15 years). For the year ended June 30, 2013, the Company recorded an impairment of \$357,500 as a result of the closing of a scanning center in New York.

### 4) Non-Competition Agreements

The non-competition agreements are being amortized on the straight line basis over the length of the agreement (7 years).

### 5) Customer Relationships

Amortization is calculated on the straight line basis over 20 years.

FONAR CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2014 and 2013

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Goodwill

Generally accepted accounting principles in the United States require the Company to perform a goodwill impairment test annually and more frequently when negative conditions or a triggering event arises. Impairment of goodwill is tested at the reporting unit level by comparing the reporting unit's carrying amount, including goodwill to the fair value of the reporting unit. If the carrying amount of the reporting unit exceeds its fair value, goodwill is considered potentially impaired and a second step is performed to measure the amount of impairment loss, if any.

Acquired assets and assumed liabilities

Pursuant to ASC No. 805-10-25, if the initial accounting for a business combination is incomplete by the end of the reporting period in which the combination occurs, but during the allowed measurement period not to exceed one year from the acquisition date, the Company retrospectively adjusts the provisional amounts recognized at the acquisition date by means of adjusting the amount recognized for goodwill.

Revenue Recognition

Revenue on sales contracts for scanners, included in "product sales" in the accompanying consolidated statements of operations, is recognized under the percentage-of-completion method in accordance with FASB ASC 605-35, "Revenue Recognition – Construction-Type and Production-Type Contracts". The Company manufactures its scanners under specific contracts that provide for progress payments. Production and installation take approximately three to six months.

Revenue on scanner service contracts is recognized on the straight-line method over the related contract period, usually one year.

Revenue from sales of other items is recognized upon shipment.

Revenue under management contracts is recognized based upon contractual agreements for management services rendered by the Company primarily under various long-term agreements with various medical providers (the "PCs"). As of June 30, 2014, the Company has twenty management agreements of which three are with PC's owned by Raymond V. Damadian, M.D., President and Chairman of the Board of FONAR ("the Related medical practices") and seventeen are with PC's, which are all located in the state of New York ("the New York PC's"), owned by two unrelated radiologists. The contractual fees for services rendered to the PCs consists of fixed monthly fees per diagnostic imaging facility ranging from approximately \$35,000 to \$242,000. All fees are re-negotiable at the anniversary of the agreements and each year thereafter. Revenue under lease contracts is recognized based upon contractual agreements for the leasing of medical equipment primarily under long term contracts to various unrelated PC's. The lease fees for the medical equipment consist of fixed monthly fees ranging from \$2,000 to \$19,000. All fees are re-negotiable at the anniversary of the agreements and each year thereafter.

## FONAR CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2014 and 2013

## NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Revenue Recognition (Continued)

Patient fee revenue, net of contractual allowance and discounts, consist of net patient fees received from insurance companies, third party payors (including federal and state agencies under Medicare and Medicaid programs), hospitals and patients themselves based mainly upon established contractual billing rates, less allowances for contractual adjustments and discounts. Patient fee revenue is recorded in the period in which services are provided.

The Company's patient fee revenue, net of contractual allowances and discounts less the provision for bad debts for the years ended June 30, 2014 and 2013 are summarized in the following table.

|  | For the Year Ended June 30, |             |
|--|-----------------------------|-------------|
|  | 2014                        | 2013        |
| Commercial Insurance/ Managed Care                               | \$4,217,088                 | \$1,360,536 |
| Medicare/Medicaid  | 1,443,020                   | 541,602     |
| Workers' Compensation/Personal Injury                            | 13,369,956                  | 3,597,416   |
| Other  | 5,277,128                   | 1,982,311   |
| Patient Fee Revenue, net of contractual allowances and discounts | 24,307,192                  | 7,481,865   |
| Provision for Bad Debts  | (10,333,082)                | (2,584,669) |
| Net Patient Fee Revenue  | \$13,974,110                | \$4,897,196 |

Allowance for Doubtful Accounts – Patient Fee

The Company provides for medical receivables that could become uncollectible by establishing an allowance for doubtful accounts in order to adjust medical receivables to estimated net realizable value. In evaluating the collectability of medical receivables, the Company considers a number of factors, including the age of the account, historical collection experiences, payor type, current economic conditions and other relevant factors. There are various factors that impact collection trends, such as payor mix, changes in the economy, increase burden on copayments to be made by patients with insurance and business practices related to collection efforts. These factors continuously change and can have an impact on collection trends and the estimation process.

FONAR CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2014 and 2013

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Research and Development Costs

Research and development costs are charged to expense as incurred. The costs of materials and equipment that are acquired or constructed for research and development activities, and have alternative future uses (either in research and development, marketing or production), are classified as property and equipment and depreciated over their estimated useful lives.

Advertising Costs

Advertising costs are expensed as incurred. Advertising expense approximated \$889,000 and \$835,000 for the years ended June 30, 2014 and 2013, respectively.

Shipping Costs

The Company's shipping and handling costs are included in revenue from product sales and the related expense included in costs related to product sales is \$1,885 and \$5,838 for the years ended June 30, 2014 and 2013, respectively.

Income Taxes



Deferred tax assets and liabilities are determined based on the difference between the financial statement carrying amounts and tax basis of assets and liabilities using enacted tax rates in effect in the years in which the differences are expected to reverse.

### Customer Advances

Cash advances and progress payments received on sales orders are reflected as customer advances until such time as revenue recognition begins.

### Earnings Per Share

Basic earnings per share (“EPS”) is computed based upon the weighted average number of shares of common stock and stock equivalents outstanding, net of common stock. In accordance with ASC topic 260-10, “Participating Securities and the Two-Class Method”, the Company used the Two-Class method for calculating basic earnings per share and applied the if converted method in calculating diluted earnings per share for the years ended June 30, 2014 and June 30, 2013.

## FONAR CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2014 and 2013

## NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Earnings Per Share (Continued)

Diluted EPS reflects the potential dilution from the exercise or conversion of all dilutive securities into common stock based on the average market price of common shares outstanding during the period. For both the year ended June 30, 2014 and June 30, 2013, diluted EPS for common shareholders includes 127,504 shares upon conversion of Class C Common.

|  | June 30, 2014 |              |                      |
|--|---------------|--------------|----------------------|
|  | Total         | Common Stock | Class C Common Stock |
| Basic  |               |              |                      |
| Numerator:                                       |               |              |                      |
| Net income Available to common stockholders      | \$10,396,130  | \$9,720,030  | \$172,189            |
| Denominator:                                     |               |              |                      |
| Weighted average shares outstanding              | 6,009,822     | 6,009,822    | 382,513              |
| Basic income per common share                    | \$1.73        | \$1.62       | \$0.45               |
| Diluted  |               |              |                      |
| Denominator:                                     |               |              |                      |
| Weighted average shares outstanding              |               | 6,009,822    | 382,513              |
| Class C Common Stock                             |               | 127,504      | —                    |
| Total Denominator for diluted earnings per share |               | 6,137,326    | 382,513              |
| Diluted income per common share                  |               | \$1.58       | \$0.45               |

|   | June 30, 2013 |              |                      |
|---|---------------|--------------|----------------------|
|   | Total         | Common Stock | Class C Common Stock |
| Basic                                       |               |              |                      |
| Numerator:                                  |               |              |                      |
| Net income Available to common stockholders | \$8,678,542   | \$8,107,367  | \$145,467            |

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Denominator:

|                                     |           |           |         |
|-------------------------------------|-----------|-----------|---------|
| Weighted average shares outstanding | 5,933,318 | 5,933,318 | 382,513 |
| Basic income per common share       | \$1.46    | \$1.37    | \$0.38  |

Diluted

Denominator:

|  |   |           |         |
|--|---|-----------|---------|
| Weighted average shares outstanding              |   | 5,933,318 | 382,513 |
| Class C Common Stock                             |   | 127,504   | —       |
| Total Denominator for diluted earnings per share |   | 6,060,822 | 382,513 |
| Diluted income per common share                  | . | \$1.34    | \$0.38  |

FONAR CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2014 and 2013

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Cash and Cash Equivalents

The Company considers all short-term highly liquid investments with a maturity of three months or less when purchased to be cash equivalents.

Concentration of Credit Risk

Cash: The Company maintains its cash and cash equivalents with various financial institutions, which exceed federally insured limits throughout the year. At June 30, 2014, the Company had cash on deposit of approximately \$8,035,000 in excess of federally insured limits of \$250,000.

Related Parties: Net revenues from related parties accounted for approximately 11% and 16% of the consolidated net revenues for the years ended June 30, 2014 and 2013, respectively. Net management fee receivables from the related medical practices accounted for approximately 12% and 9% of the consolidated accounts receivable for the years ended June 30, 2014 and 2013, respectively.

See Note 3 regarding the Company's concentrations in the healthcare industry.

Fair Value of Financial Instruments

The financial statements include various estimated fair value information at June 30, 2014 and 2013, as required by ASC topic 820, "Disclosures about Fair Value of Financial Instruments". Such information, which pertains to the Company's financial instruments, is based on the requirements set forth in that Statement and does not purport to represent the aggregate net fair value to the Company.

The following methods and assumptions were used to estimate the fair value of each class of financial instruments for which it is practicable to estimate that value:

Cash and cash equivalents: The carrying amount approximates fair value because of the short-term maturity of those instruments.

Receivable and accounts payable: The carrying amounts approximate fair value because of the short maturity of those instruments.

Notes receivable: The carrying amount approximates fair value because the discounted present value of the cash flow generated by the parties approximates the carrying value of the amounts due to the Company.

Long-term debt, notes payable and accounts payable: The carrying amounts of debt and notes payable approximate fair value due to the length of the maturities, the interest rates being tied to market indices and/or due to the interest rates not being significantly different from the current market rates available to the Company.

All of the Company's financial instruments are held for purposes other than trading.

FONAR CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2014 and 2013

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Recent Accounting Pronouncements

The FASB has issued ASU No. 2013-11, *Income Taxes (Topic 740): Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists* (a consensus of the FASB Emerging Issues Task Force). The amendments in this ASU state that an unrecognized tax benefit, or a portion of an unrecognized tax benefit, should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, except as follows. To the extent a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date under the tax law of the applicable jurisdiction to settle any additional income taxes that would result from the disallowance of a tax position or the tax law of the applicable jurisdiction does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purpose, the unrecognized tax benefit should be presented in the financial statements as a liability and should not be combined with deferred tax assets. The amendments in this ASU are effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. Early adoption is permitted. The amendments should be applied prospectively to all unrecognized tax benefits that exist at the effective date. Retrospective application is permitted. The adoption of this standard did not have a material impact on the Company's consolidated financial position and results of operations.

The FASB has issued ASU No. 2014-09, *Revenue from Contracts with Customers*. This ASU supercedes the revenue recognition requirements in Accounting Standards Codification 605 - Revenue Recognition and most industry-specific guidance throughout the Codification. The standard requires that an entity recognizes revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services. This ASU is effective on January 1, 2017 and should be applied retrospectively to each prior reporting period presented or retrospectively with the cumulative effect of initially applying the ASU recognized at the date of initial application. The adoption of this standard is not expected to have a material impact on the Company's consolidated financial position and results of operations.

FASB, the Emerging Issues Task Force and the SEC have issued certain other accounting standards, updates, and regulations as of June 30, 2014 that will become effective in subsequent periods; however, management does not

believe that any of those updates would have significantly affected our financial accounting measures or disclosures had they been in effect during 2014 or 2013, and it does not believe that any of those pronouncements will have a significant impact on our consolidated financial statements at the time they become effective.

### Reclassifications

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

FONAR CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2014 and 2013

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

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

Accounts Receivable

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

Medical Receivable

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



Management and Other Fees Receivable

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

Payment of the management fee receivables from the PC's may be impaired by the inability of the PC's to collect in a timely manner their medical fees from the third party payors, particularly insurance carriers covering automobile no-fault and workers compensation claims due to longer payment cycles and rigorous informational requirements and certain other disallowed claims. Approximately 50% and 41%, respectively, of the PCs' 2014 and 2013 net revenues were derived from no-fault and personal injury protection claims. The Company considers the aging of its accounts receivable in determining the amount of allowance for doubtful accounts. The Company generally takes all legally available steps to collect its receivables. Credit losses associated with the receivables are provided for in the consolidated financial statements and have historically been within management's expectations.

FONAR CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2014 and 2013

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

Management and Other Fees Receivable (Continued)

Net revenues from management and other fees charged to the related medical practices accounted for approximately 11% and 16%, of the consolidated net revenues for the years ended June 30, 2014 and 2013, respectively.

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

The following table sets forth the number of our facilities for the year end June 30, 2014 and 2013.

|  | For The<br>Year<br>Ended<br>June 30,<br>2014 2013 |     |
|--|---|-----|
| Total Facilities Owned or Managed (at Beginning of Year) | 24  | 11  |
| Facilities Added by:                                     |   |     |
| Acquisition  | —   | 14  |
| Internal development                                     | 1   | —   |
| Managed Facilities Closed                                | (1)   | (1) |
| Total Facilities Owned or Managed (at End of Year)       | 24  | 24  |

NOTE 4 - COSTS AND ESTIMATED EARNINGS ON UNCOMPLETED CONTRACTS AND CUSTOMER ADVANCES

Information relating to uncompleted contracts as of June 30, 2014 and 2013 is as follows:

|   | As of June 30, |             |
|---|----------------|-------------|
|   | 2014           | 2013        |
| Costs incurred on uncompleted contracts | \$1,884,984    | \$1,482,384 |
| Estimated earnings                      | 1,745,608      | 1,191,141   |
|   | 3,630,592      | 2,673,525   |
| Less: Billings to date                  | 3,013,000      | 2,370,000   |
|   | \$617,592      | \$303,525   |

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

|   | As of June 30, |           |
|---|----------------|-----------|
|   | 2014           | 2013      |
| Costs and estimated earnings in excess of billings on uncompleted contracts       | \$759,809      | \$445,742 |
| Less: Billings in excess of costs and estimated earnings on uncompleted contracts | 142,217        | 142,217   |
|   | \$617,592      | \$303,525 |

## FONAR CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2014 and 2013

## NOTE 5 – INVENTORIES

Inventories included in the accompanying consolidated balance sheets consist of:

|  | As of June 30, |             |
|--|----------------|-------------|
|  | 2014           | 2013        |
| Purchased parts, components and supplies | \$2,093,671    | \$1,783,847 |
| Work-in-process                          | 349,865        | 293,241     |
|  | \$2,443,536    | \$2,077,088 |

## NOTE 6 - PROPERTY AND EQUIPMENT

Property and equipment, at cost, less accumulated depreciation and amortization, at June 30, 2014 and 2013, is comprised of:

|   | As of June 30, |              |
|---|----------------|--------------|
|   | 2014           | 2013         |
| Diagnostic equipment under capital leases         | \$620,307      | \$620,307    |
| Diagnostic equipment                              | 17,396,797     | 18,567,787   |
| Research, development and demonstration equipment | 3,510,224      | 3,500,902    |
| Machinery and equipment                           | 2,069,055      | 4,987,159    |
| Furniture and fixtures                            | 2,550,627      | 2,952,449    |
| Leasehold improvements                            | 5,593,148      | 5,669,338    |
| Building  | 939,614        | 939,614      |
|   | 32,679,772     | 37,237,556   |
| Less: Accumulated depreciation and amortization   | 17,650,043     | 19,713,062   |
|   | \$15,029,729   | \$17,524,494 |

Depreciation and amortization of property and equipment for the years ended June 30, 2014 and 2013 was \$2,458,113 and \$1,554,458, respectively.

Depreciation and amortization of diagnostic equipment under capital leases for the years ended June 30, 2014 and 2013 was \$95,026 and \$248,123, respectively. Accumulated depreciation and amortization of diagnostic equipment under capital leases for the years ended June 30, 2014 and 2013 was \$620,307 and \$525,281, respectively.

During the year ended June 30, 2014, the Company has retired assets that were fully depreciated with a cost and accumulated depreciation basis of \$4,418,903.

## FONAR CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2014 and 2013

## NOTE 7 - OTHER INTANGIBLE ASSETS

Other intangible assets, net of accumulated amortization, at June 30, 2014 and 2013 are comprised of:

|  | As of June 30, |              |
|--|----------------|--------------|
|  | 2014           | 2013         |
| Capitalized software development costs | \$7,418,436    | \$7,668,959  |
| Patents and copyrights                 | 4,408,011      | 4,193,800    |
| Non-competition agreements             | 4,100,000      | 4,100,000    |
| Customer relationships                 | 3,800,000      | 3,800,000    |
|  | 19,726,447     | 19,762,759   |
| Less: Accumulated amortization         | 9,217,604      | 7,858,511    |
|  | \$10,508,843   | \$11,904,248 |

Information related to the above intangible assets for the years ended June 30, 2014 and 2013 is as follows:

|   | As of June 30, |              |
|---|----------------|--------------|
|   | 2014           | 2013         |
| Balance – Beginning of Year             | \$11,904,248   | \$3,835,179  |
| Amounts capitalized                     | 214,211        | 9,359,907    |
| Abandon software or patents written off | (250,523 )     | (66,619 )    |
| Impairment of management agreement      | —              | (357,500 )   |
| Amortization                            | (1,359,093 )   | (866,719 )   |
| Balance – End of Year                   | \$10,508,843   | \$11,904,248 |

Amortization of patents and copyrights for the years ended June 30, 2014 and 2013 amounted to \$178,836 and \$168,631, respectively.

Amortization of capitalized software development costs for the years ended June 30, 2014 and 2013 was \$407,876 and \$335,350, respectively.

Amortization of management agreement for the years ended June 30, 2014 and 2013 amounted to \$0 and \$100,833, respectively.

Amortization of non-competition agreements for the years ended June 30, 2014 and 2013 amounted to \$585,714 and \$195,238, respectively.

Amortization of customer relationships for the years ended June 30, 2014 and 2013 amounted to \$186,667 and \$66,667, respectively.

## FONAR CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2014 and 2013

## NOTE 7 - OTHER INTANGIBLE ASSETS (Continued)

The estimated amortization of other intangible assets for the five years ending June 30, 2019 and thereafter is as follows:

| For the<br>Years<br>Ending<br>June 30, | Total         | Patents and<br>Copyrights | Capitalized<br>Software<br>Development<br>Costs | Non-<br>competition | Customer<br>Relationships |
|--|---------------|---------------------------|---|---------------------|---------------------------|
| 2015                                   | \$ 1,328,315  | \$ 189,559                | \$ 363,042                                      | \$ 585,714          | \$ 190,000                |
| 2016                                   | 1,347,439     | 205,114                   | 366,611   | 585,714             | 190,000                   |
| 2017                                   | 1,368,582     | 220,668                   | 372,200   | 585,714             | 190,000                   |
| 2018                                   | 1,329,294     | 230,647                   | 322,933   | 585,714             | 190,000                   |
| 2019                                   | 1,043,968     | 228,665                   | 39,589  | 585,714             | 190,000                   |
| Thereafter                             | 4,091,245     | 1,104,100                 | —   | 390,478             | 2,596,667                 |
|  | \$ 10,508,843 | \$ 2,178,753              | \$ 1,464,375                                    | \$ 3,319,048        | \$ 3,546,667              |

The weighted average amortization period for other intangible assets is 11.0 years and they have no expected residual value.

## NOTE 8 - CAPITAL STOCK

Common Stock



Cash dividends payable on the common stock shall, in all cases, be on a per share basis, one hundred twenty percent (120%) of the cash dividend payable on shares of Class B common stock and three hundred sixty percent (360%) of the cash dividend payable on a share of Class C common stock.

#### Class B Common Stock

Class B common stock is convertible into shares of common stock on a one-for-one basis. Class B common stock has 10 votes per share. There were 146 and 146 of such shares outstanding at June 30, 2014 and 2013, respectively.

#### Class C Common Stock

On April 3, 1995, the stockholders ratified a proposal creating a new Class C common stock and authorized the exchange offering of three shares of Class C common stock for each share of the Company's outstanding Class B common stock. The Class C common stock has 25 votes per share, as compared to 10 votes per share for the Class B common stock and one vote per share for the common stock. The Class C common stock was offered on a three-for-one basis to the holders of the Class B common stock. Although having greater voting power, each share of Class C common stock has only one-third of the rights of a share of Class B common stock to dividends and distributions. Class C common stock is convertible into shares of common stock on a three-for-one basis.

FONAR CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2014 and 2013

NOTE 8 - CAPITAL STOCK (Continued)

Class A Non-Voting Preferred Stock

On April 3, 1995, the stockholders ratified a proposal consisting of the creation of a new class of Class A non-voting preferred stock with special dividend rights and the declaration of a stock dividend on the Company's common stock consisting of one share of Class A non-voting preferred stock for every five shares of common stock. The stock dividend was payable to holders of common stock on October 20, 1995. Class A non-voting preferred stock issued pursuant to such stock dividend approximates 313,000 shares.

The Class A non-voting preferred stock is entitled to a special dividend equal to 3-1/4% of first \$10 million, 4-1/2% of next \$20 million and 5-1/2% on amounts in excess of \$30 million of the amount of any cash awards or settlements received by the Company in connection with the enforcement of five of the Company's patents in its patent lawsuits, less the revised special dividend payable on the common stock with respect to one of the Company's patents.

The Class A non-voting preferred stock participates on an equal per share basis with the common stock in any dividends declared and ranks equally with the common stock on distribution rights, liquidation rights and other rights and preferences (other than the voting rights).

Stock Bonus Plans

On April 23, 2010, the Board approved the 2010 Stock Bonus Plan. The plan entitles the Company to reserve 2,000,000 shares of common stock. On August 10, 2010, the Company filed Form S-8 to register the 2,000,000 shares. As of June 30, 2014, 958,367 shares of common stock of FONAR were available for future grant under this plan. For the years ended June 30, 2014 and 2013, 46,708 and 67,870 shares were issued, respectively.

Options

The Company has stock option plans, which provide for the awarding of incentive and non-qualified stock options to employees, directors and consultants who may contribute to the success of the Company. The options granted vest either immediately or ratably over a period of time from the date of grant, typically three or four years, at a price determined by the Board of Directors or a committee of the Board of Directors, generally the fair value of the Company's common stock at the date of grant. The options must be exercised within ten years from the date of grant.

FONAR's 2002 Incentive Stock Option Plan (the "FONAR 2002 Plan"), adopted on July 1, 2002, is intended to qualify as an incentive stock option plan under Section 422A of the Internal Revenue Code of 1954, as amended. The FONAR 2002 Plan permits the issuance of stock options covering an aggregate of 100,000 shares of common stock of FONAR. The options have an exercise price equal to the fair market value of the underlying stock on the date the option is granted, are nontransferable, are exercisable for a period not exceeding ten years and expire upon the voluntary termination of employment. The FONAR 2002 Plan terminated on June 30, 2012. During the year ended June 30, 2014, 6,610 options expired, therefore no options remain outstanding.

## FONAR CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2014 and 2013

## NOTE 8 - CAPITAL STOCK (Continued)

Options (Continued)

FONAR's 2005 Incentive Stock Option Plan (the "FONAR 2005 Plan"), adopted on February 16, 2005, is intended to qualify as an incentive stock option plan under Section 422A of the Internal Revenue Code of 1954, as amended. The FONAR 2005 Plan permits the issuance of stock options covering an aggregate of 80,000 shares of common stock of FONAR. The options have an exercise price equal to the fair value of the underlying stock on the date the option is granted, are non-transferable, are exercisable for a period not exceeding ten years, and expire upon the voluntary termination of employment. The FONAR 2005 Plan will terminate on February 14, 2015. As of June 30, 2014, 70,000 shares of common stock of FONAR were available for future grant under this Plan.

Stock option activity and weighted average exercise prices under these plans and grants for the years ended June 30, 2014 and 2013 were as follows:

|                            | Number<br>of<br>Options | Weighted<br>Average<br>Exercise<br>Price | Aggregate<br>Intrinsic<br>Value |
|----------------------------|-------------------------|--|---------------------------------|
| Outstanding, June 30, 2012 | 14,022                  | 27.76                                    | —                               |
| Granted                    | —                       | —  | —                               |
| Exercised                  | —                       | —  | —                               |
| Forfeited / Expired        | (7,412 )                | 26.65                                    | —                               |
| Outstanding, June 30, 2013 | 6,610                   | 29.00                                    | —                               |
| Granted                    | —                       | —  | —                               |
| Exercised                  | —                       | —  | —                               |
| Forfeited / Expired        | (6,610 )                | 29.00                                    | —                               |
| Outstanding, June 30, 2014 | —                       | —  | —                               |
| Exercisable at:            |                         |  |                                 |
| June 30, 2013              | 6,610                   | \$ 29.00                                 |                                 |

June 30, 2014                      —                      \$ —

FONAR CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2014 and 2013

NOTE 9 – CONTROLLING AND NONCONTROLLING INTERESTS

On February 13, 2013 the Company entered into an agreement with outside investors to acquire a 50.5% controlling interest in a newly formed limited liability company, Health Diagnostics Management LLC (HDM). According to the February 13, 2013 LLC operating agreement of HDM there are two classes of members; Class A members and one Class B member. The Class A members have an ownership interest of 49.5% of HDM. The Class B member (HMCA) has an ownership of 50.5% of HDM. On all matters on which members may vote every member is entitled to cast the percentage of votes equal to their percentage of ownership interest. Profits and losses on all items of income, gain or loss, deductions or other allocations of the Company will be allocated among the members in the same proportions as their membership interests in the Company bear to all the Class A and Class B membership interests of the Company in the aggregate outstanding. All of the depreciation and amortization of the assets of the Company will be allocated solely to the Class A members, unless and until their interests have been redeemed by the Company in full pursuant to the provisions of the operating agreement. During March 2013 the Company contributed \$20,200,000 to HDM and the group of outside investors contributed \$19,800,000 for its non-controlling membership interest.

To fund its capital contribution the Company borrowed a total of \$14,000,000 from a bank in the form of a term loan aggregating \$11,000,000 and a revolving credit loan aggregating \$3,000,000. The term loan is payable in 60 consecutive monthly installments, commencing September 1, 2013. The term loan bears interest at 4.75% per annum and is payable monthly. The revolving credit loan is due March 5, 2016. The Company can prepay the loan in whole or in part in multiples of \$100,000 at any time without penalty. The revolving credit note bears interest at a rate of 4% per annum and is payable monthly. All borrowings under the loan agreements are collateralized by substantially all of the Company's assets. The loan agreements also contain certain financial covenants that must be met on a periodic basis.

On March 5, 2013 HDM purchased from Health Diagnostics, LLC (“HD”) and certain of its subsidiaries, a business managing twelve (12) Stand-Up® MRI Centers and two (2) other scanning centers located in the States of New York and Florida for a total purchase price (including consideration of \$1.5 million to outside investors) aggregating \$35.9 million. Concurrently with the acquisition, HDM entered into several consulting and non-competition agreements for a consideration of \$4.1 million. The acquisition was accounted for using the purchase method in accordance with ASC 805, “Business Combinations”. The accompanying consolidated financial statements include the operations of HDM from the date of acquisition. The Company recognizes and measures goodwill as of the acquisition date, as the excess of the fair value of the consideration paid over the fair value of the identified net assets acquired.



## FONAR CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2014 and 2013

## NOTE 9 – CONTROLLING AND NONCONTROLLING INTERESTS (Continued)

The following table summarizes the estimated fair values of the assets and liabilities assumed at the acquisition date:

|   |              |
|---|--------------|
| Management fee receivable                 | \$6,667,259  |
| Medical receivables                       | 7,389,953    |
| Prepaid expenses and other current assets | 10,262       |
| Property and equipment                    | 14,912,650   |
| Intangible assets                         | 9,200,000    |
| Goodwill                                  | 1,767,098    |
| Other assets                              | 332,949      |
| Other current liabilities                 | (6,323 )     |
| Long term debt                            | (273,848 )   |
| Net assets acquired                       | \$40,000,000 |

The purchase price was allocated to the tangible and intangible assets and liabilities assumed based on estimates of their respective fair values at the date of acquisition with the remaining unallocated purchase price recorded as goodwill. Management is responsible for the valuation of net assets acquired and considered a number of factors, including valuations and appraisals, when estimating the fair values and estimated useful lives of acquired assets and liabilities. The intangible assets, excluding goodwill, are being amortized on a straight-line basis over their weighted average lives as follows:

|                         | Fair Value  |          |
|-------------------------|-------------|----------|
| Non compete             | \$4,100,000 | 7 years  |
| Customer relationships  | 3,800,000   | 20 years |
| Developed software      | 1,300,000   | 5 years  |
| Total intangible assets | \$9,200,000 |          |



The following unaudited pro forma results of operations for the twelve months ended June 30, 2013 assumes that the above acquisitions were made at the beginning of the year of acquisition. The unaudited pro forma information does not purport to be indicative of the results that would have been obtained if the acquisitions had actually occurred at the beginning of the year prior to acquisition, nor of the results that may be reported in the future.

FONAR CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2014 and 2013

NOTE 9 – CONTROLLING AND NONCONTROLLING INTERESTS (Continued)

|  | Year ended       |
|--|------------------|
|  | June 30,<br>2013 |
| Total Revenues - Net   | 69,723,542       |
| Net Income - Controlling Interests                                     | 17,442,337       |
| Net Income Available to Common Stockholders                            | 16,294,377       |
| Net Income Available to Class A Non-Voting Preferred Stockholders      | 855,597          |
| Net Income Available to Class C Common Stockholders                    | 292,363          |
| Basic Net Income Per Common Share Available to Common Stockholders     | 2.75             |
| Diluted Net Income Per Common Share Available to Common Stockholders   | 2.69             |
| Basic and Diluted Income Per Share - Common C                          | 0.76             |
| Weighted Average Basic Shares Outstanding                              | 5,933,318        |
| Weighted Average Diluted Shares Outstanding                            | 6,060,822        |
| Weighted Average Basic and Diluted Shares Outstanding - Class C Common | 382,513          |

HDM's total net revenues and income from operations for the period from the acquisition date (March 5, 2013) to June 30, 2013 was \$14,834,143 and \$1,958,714, respectively.

Amount of each class of members' equity as of June 30, 2014 and 2013

June 30, 2014

June 30, 2013

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|                         | Class A<br>Members | Class B<br>Member | Class A<br>Members | Class B<br>Member |
|-------------------------|--------------------|-------------------|--------------------|-------------------|
| Opening Members' Equity | \$19,526,475       | \$20,763,830      | \$—                | \$—               |
| Share of Net Income     | 2,266,473          | 4,566,186         | 543,225            | 1,397,080         |
| Contributions           | —                  | —                 | 19,800,000         | 20,200,000        |
| Distributions           | (4,133,250 )       | (4,216,750 )      | (816,750 )         | (833,250 )        |
| Ending Members' Equity  | \$17,659,698       | \$21,113,266      | \$19,526,475       | \$20,763,830      |

## FONAR CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2014 and 2013

## NOTE 9 – CONTROLLING AND NONCONTROLLING INTERESTS (Continued)

On May 2, 2011, the Company completed a private placement of equity and succeeded in raising \$6,000,000. The offering consisted of Preferred Class A membership interests in a newly formed limited liability company, Imperial Management Services, LLC (“Imperial”). The Class B membership interests in Imperial, all of which were retained by the Company’s subsidiary, HMCA, hold a 75% equity interest in Imperial. The Class A membership interests are entitled to receive a dividend of 18% per annum of their cash capital contribution of \$6,000,000. HMCA contributed all of its assets, together with its liabilities, to Imperial as HMCA’s capital contribution. The Imperial operating agreement provides for the Class A members to receive priority distributions until their original capital contributions are returned. Dividends are payable quarterly beginning August 1, 2011. On May 1, 2014 and on May 1, 2013, the Company returned a portion of the Class A Members capital contribution in the amount of \$1,125,100 and \$1,424,900, respectively. As of June 30, 2014, the Company’s subsidiary, HMCA, now owns approximately 91% interest in Imperial Management Services.

Amount of each class of members’ equity as of June 30, 2014 and 2013

|                         | June 30, 2014   |                | June 30, 2013   |                |
|-------------------------|-----------------|----------------|-----------------|----------------|
|                         | Class A Members | Class B Member | Class A Members | Class B Member |
| Opening Members’ Equity | \$3,599,519     | \$7,772,781    | \$4,918,365     | \$3,824,945    |
| Share of Net Income     | 536,913         | 3,306,536      | 959,254         | 3,947,836      |
| Contributions           | —               | —              | —               | —              |
| Distributions           | (607,520)       | ) —            | (853,200)       | ) —            |
| Redemption              | (1,125,100)     | ) —            | (1,424,900)     | ) —            |
| Ending Members’ Equity  | \$2,403,812     | \$11,079,317   | \$3,599,519     | \$7,772,781    |

On May 1, 2010, the Company purchased a 15.2% interest from an unrelated party of an entity that provides management services to a diagnostic center in the New York Metropolitan area. On January 1, 2011, the Company purchased an additional 34.8% interest by the issuance of a promissory note of \$400,000. Commencing January 1, 2011, the Company consolidates the activity of this entity. On June 1, 2013, the Company purchased from the noncontrolling members their remaining 50% interest for \$700,000.

The Company also has a 50% controlling interest in an entity which the Company consolidates, that provides management services to a diagnostic center in the New York Metropolitan area. The center began operations during January 2012. The noncontrolling interest as of June 30, 2014 and 2013 aggregated \$531,474 and \$559,221, respectively.

## FONAR CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2014 and 2013

## NOTE 10 - LONG-TERM DEBT, NOTES PAYABLE AND CAPITAL LEASES

Long-term debt, notes payable and capital leases consist of the following:

|   | June 30,<br>2014 | 2013         |
|---|------------------|--------------|
| Note payable requiring monthly payments of interest at a rate of 7% until May 2009 followed by 240 monthly payments of \$4,472 through October 2026. The loan is collateralized by a building with a net book value of \$652,505 as of June 30, 2014.   | \$439,983        | \$461,648    |
| The revolving credit note is due by March 5, 2016. The Company can prepay the loan in whole or part in multiples of \$100,000 at any time without penalty. The note bears interest at a rate of 4% per annum and is payable monthly. The loan is collateralized by substantially all of the Company's assets. The loan also contains certain financial covenants that must be met on a periodic basis.                              | 300,000          | 2,400,000    |
| The term loan is payable with interest only for 6 consecutive months commencing at the inception of the loan followed by 60 consecutive monthly installments, commencing October 1, 2013. The term loan bears interest at 4.75% per annum and is payable monthly. The loan is collateralized by substantially all of the Company's assets. The loan also contains certain financial covenants that must be met on a periodic basis. | 9,349,994        | 11,000,000   |
| Note payable requiring 12 consecutive interest only payments commencing at the inception of the loan followed by 48 consecutive monthly payments, commencing May 1, 2014. The note bears interest at a rate of 4.75% per annum and is payable monthly. The loan is collateralized by substantially all of the Company's assets. The loan also contains certain financial covenants that must be met on a periodic basis.            | 660,911          | 689,646      |
| Other (including capital leases for property and equipment).  | 621,758          | 1,221,480    |
|   | 11,372,646       | 15,772,774   |
| Less: Current portion   | 2,890,816        | 2,885,769    |
|   | \$8,481,830      | \$12,887,005 |



## FONAR CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2014 and 2013

## NOTE 10 - LONG-TERM DEBT, NOTES PAYABLE AND CAPITAL LEASES (Continued)

The maturities of long-term debt over the next five years and thereafter are as follows:

| Years<br>Ending<br>June 30, |              |
|-----------------------------|--------------|
| 2015                        | \$2,890,816  |
| 2016                        | 2,782,561    |
| 2017                        | 2,440,108    |
| 2018                        | 2,372,330    |
| 2019                        | 580,891      |
| Thereafter                  | 305,940      |
|                             | \$11,372,646 |

## NOTE 11 - INCOME TAXES

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



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

The Company files corporate income tax returns in the United States (federal) and in various state and local jurisdictions. In most instances, the Company is no longer subject to federal, state and local income tax examinations by tax authorities for years prior to 2009.

The Company netted a deferred tax asset of \$5,740,287 and a deferred tax liability of \$583,990 as of June 30, 2014, primarily relating to net operating loss carryforwards of approximately \$137,252,000 available to offset future taxable income through 2034. The net operating losses begin to expire in 2019 for federal tax purposes and in 2014 for state income tax purposes.

## FONAR CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2014 and 2013

## NOTE 11 - INCOME TAXES (Continued)

The ultimate realization of deferred tax assets is dependent on the generation of future taxable income during the periods in which those temporary differences become deductible. The Company considers projected future taxable income and tax planning strategies in making this assessment. At present, the Company does have a sufficient history of income and anticipates profitability in the coming years and has concluded that it is more-likely-than-not that the Company will be able to realize a portion of its tax benefits in the near future and therefore a valuation allowance was established for the partial value of the deferred tax asset.

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

Components of the current (benefit) provision for income taxes are as follows:

|                | Years Ended June 30, |               |
|----------------|----------------------|---------------|
|                | 2014                 | 2013          |
| Current:       |                      |               |
| Federal        | \$310,000            | \$125,000     |
| State          | 24,093               | 71,001        |
| Deferred taxes | (2,682,405)          | (2,473,892)   |
|                | \$(2,348,312)        | \$(2,277,891) |

A reconciliation of the federal statutory income tax rate to the Company's effective tax rate as reported is as follows:

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|  | Years Ended June |         |
|--|------------------|---------|
|  | 30,              |         |
|  | 2014             | 2013    |
| Taxes at federal statutory rate                                | 34.0 %           | 34.0 %  |
| State and local income taxes (benefit), net of federal benefit | 6.0 %            | 6.0 %   |
| Permanent differences  | (0.9 )%          | 0.6 %   |
| (Decrease) increase in the valuation allowance and true ups    | (68.3)%          | (76.2)% |
| Effective income tax rate                                      | (29.2)%          | (35.6)% |

## FONAR CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2014 and 2013

## NOTE 11 - INCOME TAXES (Continued)

As of June 30, 2014, the Company has net operating loss (“NOL”) carryforwards of approximately \$137,252,000 that will be available to offset future taxable income. The utilization of certain of the NOLs is limited by separate return limitation year rules pursuant to Section 1502 of the Internal Revenue Code.

The Company has, for federal income tax purposes, research and development tax credit carryforwards aggregating \$3,742,000, which are accounted for under the flow-through method. The Company also has \$578,000 in alternative minimum tax credits.

In addition, for New York State income tax purposes, the Company has tax credit carryforwards, aggregating approximately \$1,133,000, which are accounted for under the flow-through method. The tax credit carryforwards expire during the years ending June 30, 2014 to June 30, 2029.

Significant components of the Company's deferred tax assets and liabilities at June 30, 2014 and 2013 are as follows:

|   | June 30,<br>2014 | 2013         |
|---|------------------|--------------|
| Deferred tax assets:                    |                  |              |
| Allowance for doubtful accounts         | \$6,961,016      | \$6,139,291  |
| Non-deductible accruals                 | 65,108           | 264,062      |
| Net operating carryforwards             | 54,900,136       | 58,052,831   |
| Tax credits                             | 5,644,097        | 5,873,204    |
| Property and equipment and depreciation | 195,408          | 1,070,291    |
| Inventory                               | 130,822          | 84,136       |
|   | 67,896,587       | 71,483,815   |
| Valuation allowance                     | (62,156,300)     | (68,548,065) |
| Total deferred tax assets               | 5,740,287        | 2,935,750    |

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|  |             |             |
|--|-------------|-------------|
| Deferred tax liabilities: Inventory    | —           | —           |
| Capitalized software development costs | (583,990 )  | (461,858 )  |
| Total deferred tax liabilities         | (583,990 )  | (461,858 )  |
| Net deferred tax asset                 | \$5,156,297 | \$2,473,892 |

The valuation allowance for deferred tax assets decreased by approximately \$6,392,000 during the year ended June 30, 2014 and decreased by approximately \$5,206,000 during the year ended June 30, 2013.

## FONAR CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2014 and 2013

## NOTE 12 - OTHER CURRENT LIABILITIES

Included in other current liabilities are the following:

|   | June 30,<br>2014 | 2013        |
|---|------------------|-------------|
| Accrued salaries, commissions and payroll taxes | \$834,324        | \$710,897   |
| Accrued interest                                | 117,480          | 117,480     |
| Litigation accruals                             | 664,349          | 809,349     |
| Sales tax payable                               | 2,665,181        | 2,858,652   |
| Legal and other professional fees               | 438,730          | 569,049     |
| Accounting fees                                 | 325,139          | 305,000     |
| Purchase scanners                               | 450,000          | —           |
| Insurance premiums                              | 306,092          | 13,443      |
| Interest and penalty – sales tax                | 2,374,339        | 2,321,858   |
| Penalty – 401k plan                             | —                | 250,000     |
| Rent  | —                | 147,665     |
| Other   | 848,399          | 390,968     |
|   | \$9,024,033      | \$8,494,361 |

## NOTE 13 - COMMITMENTS AND CONTINGENCIES

Leases

The Company rents its operating facilities and certain equipment, pursuant to operating lease agreements expiring at various dates through December 2022. The leases for certain facilities contain escalation clauses relating to increases in real property taxes as well as certain maintenance costs.

Future minimum operating lease commitments consisted of the following at June 30, 2014:

| Year Ending<br>June 30,   | Facilities<br>And<br>Equipment<br>(Operating<br>Lease) |
|---------------------------|--|
| 2015                      | \$3,753,050  |
| 2016                      | 3,042,814  |
| 2017                      | 1,295,636  |
| 2018                      | 835,680  |
| 2019                      | 351,732  |
| Thereafter                | 894,072  |
| Total minimum obligations | \$10,172,984   |

Rent expense for operating leases approximated \$4,571,000 and \$4,035,000, for the years ended June 30, 2014 and 2013, respectively. The expense for the year ended June 30, 2013 included an expense for early termination of a lease of approximately \$690,000.

FONAR CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2014 and 2013

NOTE 13 - COMMITMENTS AND CONTINGENCIES (Continued)

Employee Benefit Plans

The Company has a non-contributory 401(k) Plan (the "401(k) Plan"). The 401(k) Plan covers all non-union employees who are at least 21 years of age with no minimum service requirements. There were no employer contributions to the Plan for the years ended June 30, 2014 and 2013. (See Other Matters below)

The stockholders of the Company approved the 2000 Employee Stock Purchase Plan ("ESPP") at the Company's annual stockholders' meeting in April 2000. The ESPP provides for eligible employees to acquire common stock of the Company at a discount, not to exceed 15%. This plan has not been put into effect as of June 30, 2014.

Stipulation Agreements

The Company has entered into stipulation agreements with a number of its creditors that in the aggregate total \$305,916, which is included in other current liabilities and other liabilities on the Company's balance sheet as of June 30, 2014. The monthly payments total \$19,552.

The amounts to be paid over the next three years are as follows:

Year  
Ending  
June  
30,



|      |           |
|------|-----------|
| 2015 | \$152,166 |
| 2016 | 96,000    |
| 2017 | 57,750    |
|      | \$305,916 |

### Litigation

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

On or about June 30, 2010, one of Fonar's customers, Golden Triangle Company, commenced an action against Fonar and certain individual defendants employed or formerly employed by Fonar, in the United States District Court for the Eastern District of New York based on the alleged wrongful failure of Fonar to deliver a scanner in Kuwait. The claim alleged various causes of action including breach of contract, fraud, conspiracy to defraud and conversion.

-

Golden Triangle Company v. Fonar Corporation et al, CV10-2933. The Plaintiff contracted with Fonar to purchase a scanner, and paid \$1,455,500 in advance. The scanner was never delivered, but Plaintiff never designed a site for delivery either. Alleging other damages, fraud and deceptive trade practices, Plaintiff sought up to \$5,000,000. Fonar made a motion to dismiss the complaint, the outcome of which left Plaintiff with only a cause of action for breach of contract. The claims against the individual officers and employees of Fonar were dismissed. Fonar filed its answer, together with a counterclaim alleging that the Plaintiff, by attempting to overcharge the end-customer, had damaged Fonar's reputation and ability to sell in Kuwait. The case was settled in June 2013 for \$480,000 in cash and 30,000 shares of Fonar's common stock payable in installments. The Company recorded a gain of \$755,500 on the statements of income for the year ended June 30, 2013.

FONAR CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2014 and 2013

NOTE 13 - COMMITMENTS AND CONTINGENCIES (Continued)

Litigation (Continued)

Jack Shapiro v. Fonar Corporation, Supreme Court of the State of New York, Nassau County, was commenced by plaintiff in July, 2009 to recover \$500,000 based on Fonar's failure to refund a deposit on an MRI scanner and termination of plaintiff's sales representative agreement. Plaintiff alleged that the deposit on the machine was in part consideration for the sales representative agreement. Fonar's view was that the sales agreement and sales representative agreement were separate and (1) Fonar was entitled to keep the deposit on the sale when plaintiff failed to proceed with the transaction and (2) properly terminated the sales representative agreement in accordance with its terms. During the year ended June 30, 2013, the case has been settled for \$323,000 payable in installments, subject to the plaintiff obtaining a sale for Fonar and the payment of installments of the purchase price by the customer.

Matt Malek Madison v. Fonar Corporation, United States District Court, Northern District of California, was commenced by plaintiff on August 27, 2007 to recover a down payment for a scanner in the amount of \$300,000, with interest. The plaintiff sought costs of suit and attorney's fees as well. Fonar answered the complaint and sued the plaintiff for breach of contract in the amount of \$450,000. Although down payments are usually expressly non-refundable in Fonar's quotations and agreements, in this case, the quotation contemplated the sale of four scanners, and provided that the deposit would be refundable with interest, if the customer were unable to find suitable locations in the San Francisco Bay area. The issue was whether the customer made a good faith effort to find locations; Fonar's position was that the customer did not. The case went to trial before a judge; the parties submitted post-trial briefs, and judgment was awarded to the plaintiff. Fonar appealed the trial court's decision, but on January 31, 2012, the U.S. Court of Appeals for the 9<sup>th</sup> Circuit affirmed the lower court's decision awarding the plaintiff the \$300,000 deposit with prejudgment interest from July 1, 2006. Fonar sought to have the Court of Appeals reconsider the decision en banc, (by all or a larger number of the judges on the Circuit Court of Appeals), but this was not granted. Although the case has been concluded, the plaintiff has not taken any steps to collect the judgment. As of June 30, 2014 and 2013, \$300,000 was included in the Company's accrued expenses.

Bonutti Research v. Fonar Corporation, Health Management Corporation of America, Health Diagnostics, LLC et al, was commenced on December 2, 2011. Bonutti Research filed a patent infringement action in the U.S. District Court

for the Eastern District Court of New York, alleging that Fonar's Upright® MRI scanners infringe plaintiff's patent which relates to the moving of a patient into the scanner. Fonar believes plaintiff's claims are without merit and further, that the patent is invalid. The parties have settled the case for \$150,000 payable by Fonar in twelve installments and certain licenses and covenants not to sue. The \$150,000 has been recorded in the Company's consolidated statements of income for the year ended June 30, 2014.

Bolt MRI Technologies v. Fonar Corporation, Health Management Corporation of America & Health Diagnostics, LLC, was commenced on July 22, 2013, when Bolt MRI Technologies filed an action against Fonar Corporation, Health Management Corporation of America and Health Diagnostics, LLC alleging infringement of the same patent which is the subject of the Bonutti case. Bolt alleged that the patent was assigned to Bolt. The settlement of the Bonutti case covers this case as well.

FONAR CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2014 and 2013

NOTE 13 - COMMITMENTS AND CONTINGENCIES (Continued)

Other Matters

The Company is also delinquent in filing sales tax returns for certain states, for which the Company has transacted business. The Company has recorded tax obligations of approximately \$2,665,000 plus interest and penalties of approximately \$2,374,000. The Company is in the process of determining its regulatory requirements in order to become compliant.

On August 31, 2011 the Company submitted an application to the Internal Revenue Service to voluntarily correct required reporting and disclosure requirements regarding its 401(k) Employee Benefit Plan. On December 9, 2011, the Internal Revenue Service issued a favorable determination letter on the tax-qualified status of the 401K plan document and a favorable compliance statement. During December 2013, the Company submitted an application to the U.S. Department of Labor to voluntarily correct the late filing of prior Form 5500s (annual returns). The voluntary correction application is still pending. The Company, however, does not anticipate any additional penalties will be assessed by the U.S. Department of Labor. The Company has recorded provisions for any potential penalties totaling \$250,000, which was the Company's best estimate of its possible exposure for penalties at that time. The Company has engaged outside counsel to assist with the correction process and to obtain compliance with all reporting and disclosure requirements. The Company's actions to obtain compliance have concluded successfully and the \$250,000 reserve has been reversed.

The Company maintains a self-funded health insurance program with a stop-loss umbrella policy with a third party insurer to limit the maximum potential liability for individual claims to \$100,000 per person and for a maximum potential claim liability based on member enrollment. With respect to this program, the Company considers historical and projected medical utilization data when estimating its health insurance program liability and related expense. As of June 30, 2014 and 2013, the Company had approximately \$344,000 and \$0, respectively, in reserve for its self-funded health insurance programs. The reserves are included in "Other current liabilities" in the consolidated balance sheets.

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

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FONAR CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2014 and 2013

NOTE 14 - OTHER (EXPENSE) INCOME

Other (expense) income consists of:

|                                    | For the Years Ended<br>June 30, |             |
|------------------------------------|---------------------------------|-------------|
|                                    | 2014                            | 2013        |
| Loss from investment               | \$—                             | \$(48,777 ) |
| Litigation settlement              | 13,586                          | 716,250     |
| Loss on disposition of equipment   | (657,350)                       |             |
| Gain on sale of equipment          | 40,000                          | 557,473     |
| Impairment of management agreement | —                               | (357,500)   |
| Other expense                      | (4,835 )                        | (141,958)   |
|                                    | \$(608,599)                     | \$725,488   |

NOTE 15 - SUPPLEMENTAL CASH FLOW INFORMATION

During the years ended June 30, 2014 and 2013, the Company paid \$668,475 and \$389,907 for interest, respectively.

During the years ended June 30, 2014 and 2013, the Company paid \$349,501 and \$277,000 for income taxes, respectively.

Purchase consideration:

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|   |              |
|---|--------------|
| Assets acquired:                          |              |
| Management fee receivable                 | \$6,667,259  |
| Medical receivable                        | 7,389,953    |
| Prepaid expenses and other current assets | 10,262       |
| Property and equipment                    | 14,912,650   |
| Intangible assets                         | 9,200,000    |
| Goodwill                                  | 1,767,098    |
| Other assets                              | 332,949      |
| Total assets acquired                     | \$40,280,171 |
| Less liabilities assumed:                 |              |
| Other current liabilities                 | \$6,323      |
| Long term debt                            | 273,848      |
| Total liabilities assumed                 | \$280,171    |
|   | \$40,000,000 |

NOTE 16 – DUE TO RELATED MEDICAL PRACTICES

In June 2009, an entity owned by the Company's Chairman of the Board, Tallahassee Scanning Services PA, sold its Upright MRI scanning system to the Company for \$550,000 in exchange for 35 monthly payments of \$18,769 to be made over a three year period, commencing October 18, 2009 including interest at a rate of 10.41% per annum. The Company used this scanning system to fulfill a sales order with an unrelated customer. The unpaid balance of as of June 30, 2014 and 2013 was \$134,880.

## FONAR CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2014 and 2013

## NOTE 17 - SEGMENT AND RELATED INFORMATION

The Company provides segment data in accordance with the provisions of ASC topic 280, "Disclosures about Segments of an Enterprise and Related Information".

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

The accounting policies of the segments are the same as those described in the summary of significant accounting policies. All intersegment sales are market-based. The Company evaluates performance based on income or loss from operations.

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

|   | Manufacturing<br>and Servicing<br>of Medical<br>Equipment | Management<br>of Diagnostic<br>Imaging<br>Centers | Totals       |
|---|---|---|--------------|
| Fiscal 2014:                            |   |   |              |
| Net revenues from external customers    | \$ 12,070,563   | \$56,434,914                                      | \$68,505,477 |
| Intersegment net revenues *             | \$ 1,963,750  | \$—   | \$1,963,750  |
| Income from operations                  | \$468,793   | \$11,833,876                                      | \$12,302,669 |
| Depreciation and amortization           | \$410,728   | \$3,406,477                                       | \$3,817,205  |
| Compensatory element of stock issuances | \$223,000   | \$—   | \$223,000    |
| Total identifiable assets               | \$18,093,789  | \$58,696,054                                      | \$76,789,843 |
| Capital expenditures                    | \$234,275   | \$600,633   | \$834,908    |



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Fiscal 2013:

|   |               |               |               |
|---|---------------|---------------|---------------|
| Net revenues from external customers    | \$ 14,891,075 | \$ 34,250,739 | \$ 49,141,814 |
| Intersegment net revenues *             | \$ 1,200,000  | \$—           | \$ 1,200,000  |
| Income from operations                  | \$ 139,390    | \$ 7,396,357  | \$ 7,535,747  |
| Depreciation and amortization           | \$ 541,551    | \$ 1,879,626  | \$ 2,421,177  |
| Compensatory element of stock issuances | \$ 415,021    | \$—           | \$ 415,021    |
| Total identifiable assets               | \$ 15,071,225 | \$ 58,079,425 | \$ 73,150,650 |
| Capital expenditures                    | \$ 237,636    | \$ 25,170,303 | \$ 25,407,939 |

\* Amounts eliminated in consolidation

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## FONAR CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2014 and 2013

## NOTE 17 - SEGMENT AND RELATED INFORMATION (Continued)

Export Product Sales

The Company's areas of operations are principally in the United States. The Company had export sales of medical equipment amounting to 42.4% and 3.8% of product sales revenues to third parties for the years ended June 30, 2014 and 2013, respectively.

The foreign product sales, as a percentage of product sales to unrelated parties, were made to customers in the following countries:

|             | For the Years<br>Ended June<br>30, |      |
|-------------|------------------------------------|------|
|             | 2014                               | 2013 |
| Abu Dhabi   | 29.8%                              | -%   |
| Switzerland | 12.4                               | —    |
| England     | —                                  | 3.6  |
| Germany     | —                                  | 0.1  |
| Libya       | 0.2                                | 0.1  |
|             | 42.4%                              | 3.8% |

Foreign Service and Repair Fees

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The Company's areas of service and repair are principally in the United States. The Company had foreign revenues of service and repair of medical equipment amounting to 8.8% and 8.2% of consolidated net service and repair fees for the years ended June 30, 2014 and 2013, respectively. The foreign service and repair fees, as a percentage of total service and repair fees, were provided principally to the following countries:

|             | For the Years<br>Ended June<br>30, |      |
|-------------|------------------------------------|------|
|             | 2014                               | 2013 |
| Spain       | 1.0%                               | 0.9% |
| Puerto Rico | 1.1                                | 1.0  |
| Switzerland | 1.1                                | 1.1  |
| Germany     | .4                                 | —    |
| England     | 2.6                                | 2.0  |
| Holland     | 1.3                                | 2.2  |
| Canada      | .2                                 | —    |
| Australia   | 1.1                                | 1.0  |
|             | 8.8%                               | 8.2% |

The Company does not have any material assets outside of the United States.

## FONAR CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2014 and 2013

## NOTE 18 – ALLOWANCE FOR DOUBTFUL ACCOUNTS

The following represents a summary of allowance for doubtful accounts for the years ended June 30, 2014 and 2013, respectively:

| Description  | Balance<br>June 30,<br>2013 | Additions      | Deductions | Balance June<br>30, 2014 |
|--|-----------------------------|----------------|------------|--------------------------|
| Accounts receivable  | \$257,362                   | (1)\$—         | \$ —       | \$257,362                |
| Management and other fees receivable                             | 9,095,320                   | (1) 1,806,299  | —          | 10,901,619               |
| Management and other fees receivable - related medical practices | 403,047                     | —              | —          | 403,047                  |
| Medical receivables  | 2,584,669                   | (1) 10,333,082 | —          | 12,917,751               |
| Advance and notes to related parties                             | 202,379                     | —              | —          | 202,379                  |

| Description  | Balance<br>June 30,<br>2012 | Additions       | Deductions  | Balance<br>June 30,<br>2013 |
|--|-----------------------------|-----------------|-------------|-----------------------------|
| Accounts receivables   | \$1,852,987                 | (1)\$ (92,454 ) | \$1,503,171 | \$257,362                   |
| Management and other fees receivable                             | 7,458,345                   | (1) 950,000     | —           | 9,095,320                   |
| Management and other fees receivable - related medical practices | 403,047                     | —               | —           | 403,047                     |
| Medical receivables  | —                           | (1) 2,584,669   | —           | 2,584,669                   |
| Advance and notes to related parties                             | 239,791                     | —               | 37,412      | 202,379                     |
| Notes receivable   | 65,000                      | —               | 65,000      | —                           |

(1) Included in provision for bad debts.

NOTE 19 – SUBSEQUENT EVENTS

The Company evaluates events that have occurred after the balance sheet date, but before the consolidated financial statements are issued.

During the period from July 1, 2014 through September 29, 2014, the Company has issued 5,000 shares of common stock to employees and consultants as compensation valued at \$53,200 under a stock bonus plan.

## FONAR CORPORATION AND SUBSIDIARIES

### ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.

There have been no disagreements with our independent registered public accounting firm or other matters requiring disclosure under Regulation S-K, Item 304(b).

### ITEM 9A. CONTROLS AND PROCEDURES

#### Evaluation of Disclosure Controls and Procedures

As of the end of the period covered by this Annual Report on Form 10-K, we performed an evaluation under the supervision of and with the participation of management, including our Principal Executive Officer and our Acting Principal Financial Officer, of the design and effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) or 15d-15(e) under the Securities Exchange Act of 1934 as amended (the "Exchange Act"). We also engaged the services of a governance, risk and compliance consulting firm to assist in our evaluation and remediation. Based upon that evaluation, our Principal Executive Officer and Acting Principal Financial Officer concluded, as of the end of the period covered by this Annual Report that our disclosure controls and procedures were not effective due to material weaknesses in internal control over financial reporting as discussed and defined in Management's Report on Internal Control over Financial Reporting referred to below.

Our management has concluded that our consolidated financial statements for the periods covered by and included in this Annual Report are prepared in accordance with accounting principles generally accepted in the United States ("GAAP") and fairly present, in all material respects, our financial position, results of operations and cash flows for each of the periods presented herein.

#### Management's Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as is defined in the Exchange Act. Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of our financial reporting and the preparation of financial statements for external reporting purposes in accordance with GAAP.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Our management conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in 1992. Based on this evaluation, our management concluded that our internal control over financial reporting was not effective at June 30, 2014 because of the material weaknesses described below.

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## FONAR CORPORATION AND SUBSIDIARIES

Based on the COSO criteria, management identified control deficiencies that constitute material weaknesses. A “material weakness”, as defined by COSO, is a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is more than a reasonable possibility that a material misstatement of the Company's annual or interim financial statements will not be prevented or detected on a timely basis. Management has identified the following material weaknesses in our internal control over financial reporting:

- 1) Certain control procedures were not in place while others were unable to be verified due to performance of the procedure not being sufficiently documented. As an example, some procedures requiring review of certain reports could not be verified due to there being no written documentation of such review. Also there is insufficient documentation to verify sufficient interaction of our internal accountants with our Audit Committee. In certain instances controls were not documented or put in place.
- 2) Inadequate design of controls over period end financial reporting and disclosure processes.
- 3) We did not maintain adequate segregation of duties related to the approval and execution of certain transactions impacting our financial reporting. Management believes that all transactions have been duly authorized, however there was a lack of written evidence of such authorization, review and approval.

### Changes in Internal Controls over Financial Reporting

There have been no changes (other than those described below) in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) during the most recent fiscal quarter ended June 30, 2014 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

### Management's Plan to Remediate Material Weaknesses

None of the material weaknesses describe above resulted in audit adjustments to our 2014 annual financial statements. As a result, Management believes that the material weaknesses described above did not have an effect on our financial results or reporting of those results for the periods covered by this Annual Report. We are committed to remediating the material weaknesses described above and have developed and began implementing plans to do so for fiscal 2015. The following describes our remediation plans for fiscal 2015:



To the extent reasonably possible, we will continue to utilize the services of a governance, risk and compliance consulting firm to assist us in our remediation plan and we will utilize internal resources to implement additional internal controls as deemed necessary. We are taking steps to implement additional review and approval procedures as applicable to strengthen our controls over the financial reporting and disclosure process. In addition, we are in the planning phase of creating and implementing new information technology policies and procedures related to controls over information technology operations, security and change management. To the extent necessary, we will hire additional staff or reassign duties of existing staff in connection with our remediation efforts.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM ON INTERNAL CONTROL OVER FINANCIAL REPORTING

To the Audit Committee of the  
Board of Directors and Shareholders of  
FONAR Corporation and Subsidiaries

We have audited FONAR Corporation and Subsidiaries (the “Company”) internal control over financial reporting as of June 30, 2014, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in 1992. The Company's management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying “Management’s Annual Report on Internal Control over Financial Reporting”. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company’s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company’s assets that could have a material effect on the financial statements.

Because of the inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

A material weakness is a control deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the Company's annual or interim financial statements will not be prevented or detected on a timely basis. The following material weakness has been identified and included in "Management's Report on Internal Control Over financial Reporting".

Certain control procedures were not in place while others were unable to be verified due to performance of the procedure not being sufficiently documented. As an example, some procedures requiring review of certain reports 1) could not be verified due to there being no written documentation of such review. Also there is insufficient documentation to verify sufficient interaction of our internal accountants with our Audit Committee. In certain instances controls were not documented or put in place timely.

- 2) Inadequate design of controls over period end financial reporting and disclosure processes.

We did not maintain adequate segregation of duties related to the approval and execution of certain transactions 3) impacting our financial reporting. Management believes that all transactions have been duly authorized, however there was a lack of written evidence of such authorization, review and approval.

These material weaknesses were considered in determining the nature, timing and extent of audit tests applied in our audit of the Company's fiscal June 30, 2014 consolidated financial statements, and this report does not affect our report dated September 29, 2014.

In our opinion, because of the effect of the material weaknesses described above on the achievement of the objectives of the control criteria, the Company has not maintained effective internal control over financial reporting as of June 30, 2014, based on criteria established in Internal Control-Integrated Framework issued in 1992 by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets as of June 30, 2014 and 2013 and the related consolidated statements of income, stockholders' equity, and cash flows for the years ended June 30, 2014, and 2013 of the Company and our report dated September 29, 2014 expressed an unqualified opinion on those financial statements.

/s/ Marcum LLP

Marcum LLP

New York, New York

September 29, 2014



FONAR CORPORATION AND SUBSIDIARIES

ITEM 9B. OTHER INFORMATION

None.

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT.

Directors serve from the date of their election until the next annual meeting of stockholders and until their successors are elected and qualify. With the exception of Dr. Raymond V. Damadian, who does not receive any fees for serving as a director, each director receives \$20,000 per annum for his or her service as a director. Officers serve at the discretion of the Board of Directors.

A majority of our board of directors is composed of independent directors: Robert J. Janoff, Charles N. O'Data and Ronald G. Lehman. The outside directors also serve as the members of the audit committee, which is a standing committee of the board of directors having a charter describing its responsibilities. Mr. O'Data has been designated as the audit committee financial expert. His relevant experience is described in his biographical information.

We have adopted a code of ethics applicable to, among other personnel, our principal executive officer, principal financial officer, controllers and persons performing similar functions. The code is designed to deter wrongdoing and to promote: 1. honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships; 2. full, fair, accurate, timely and understandable disclosure in reports and documents that we file or submit to the Securities and Exchange Commission and in other public communications we make; 3. compliance with applicable governmental laws, rules and regulations; 4. the prompt internal reporting of violations of the code to an appropriate person or persons identified in the code and 5. accountability for adherence to the code. We will provide a copy of the code to any person who requests a copy. A person may request a copy by writing to Fonar Corporation, 110 Marcus Drive, Melville, New York 11747, to the attention of the Legal Department or Investor Relations.

The officers and directors of the Company are set forth below:

|                           |    |  |
|---------------------------|----|--|
| Raymond V. Damadian, M.D. | 78 | President, Treasurer, Chairman of the Board and a Director |
| Claudette J.V. Chan       | 76 | Director and Secretary                                     |
| Robert J. Janoff          | 87 | Director   |
| Charles N. O'Data         | 78 | Director   |
| Ronald G. Lehman          | 38 | Director   |

Raymond V. Damadian, M.D. has been the Chairman of the Board and President of Fonar since its inception in 1978 and Treasurer since February, 2001. Dr. Damadian was employed by the State University of New York, Downstate Medical Center, New York, as an Associate Professor of Biophysics and Associate Professor of Internal Medicine from 1967 until September 1979. Dr. Damadian received an M.D. degree in 1960 from Albert Einstein College of

Medicine, New York, and a B.S. degree in mathematics from the University of Wisconsin in 1956. In addition, Dr. Damadian conducted post-graduate work at Harvard University, where he studied extensively in the fields of physics, mathematics and electronics. Dr. Damadian is the author of numerous articles and books on the nuclear magnetic resonance effect in human tissue, which is the theoretical basis for the Fonar MRI scanners. Dr. Damadian is a 1988 recipient of the National Medal of Technology and in 1989 was inducted into the National Inventors Hall of Fame, for his contributions in conceiving and developing the application of magnetic resonance technology to medical applications including whole body scanning and diagnostic imaging. Dr. Damadian is the President, Treasurer and director of HMCA and a Manager of IMPERIAL.

## FONAR CORPORATION AND SUBSIDIARIES

Claudette J.V. Chan has been a Director of Fonar since October 1987 and Secretary of Fonar since January 2008. Mrs. Chan was employed from 1992 through 1997 by Raymond V. Damadian, M.D. MR Scanning Centers Management Company and since 1997 by HMCA, as "site inspector," in which capacity she is responsible for supervising and implementing standard procedures and policies for MRI scanning centers. From 1989 to 1994 Mrs. Chan was employed by St. Matthew's and St. Timothy's Neighborhood Center, Inc., as the director of volunteers in the "Meals on Wheels" program, a program which cares for the elderly. From approximately 1983 to 1989, Mrs. Chan was President of the Claudette Penot Collection, a retail mail-order business specializing in women's apparel and gifts. Mrs. Chan practiced and taught in the field of nursing until 1973, when her son was born. She received a bachelor of science degree in nursing from Cornell University in 1960. Mrs. Chan is the sister of Raymond V. Damadian.

Robert J. Janoff has been a Director of Fonar since February 1989. Mr. Janoff has been a self-employed New York State licensed private investigator for more than thirty-five years and was a Senior Adjustor in Empire Insurance Group for more than 15 years until retiring from that position on July 1, 1997. Mr. Janoff also served, from June 1985 to June 1991, as President of Action Data Management Strategies, Ltd., a supplier of computer programs for use by insurance companies. Mr. Janoff was a member of the Board of Directors of Harmony Heights of Oyster Bay, New York for over 25 years, which is a nonprofit residential school for girls with learning disabilities.

Charles N. O'Data has been a Director of Fonar since February 1998. From 1961 to 1997, Mr. O'Data was the Vice President for Development for Geneva College, a liberal arts college located in western Pennsylvania. In that capacity, he acted as the College's chief investment officer. His responsibilities included management of the College's endowment fund and fund raising. In July 1997, Mr. O'Data retired from Geneva College after 36 years of service to assume a position of National Sales Executive for SC Johnson Company's Professional Markets Group, a unit of SC Johnson Wax, and specialized in healthcare and education sales, a position he held until the spring of 1999. In his capacity with SC Johnson he was responsible for sales to the nation's three largest Group Purchasing Organizations which included some 4,000 hospitals. Mr. O'Data presently acts as an independent financial consultant to various entities. Mr. O'Data served on the board of The Medical Center, Beaver, Pennsylvania, now a part of Heritage Valley Health System, a 500 bed acute care facility, for 26 years, three as its Chair. Mr. O'Data also served on the board of the Hospital Council of Western Pennsylvania, a shared-services and group purchasing organization covering seven states. He founded The Beaver County Foundation, a Community Foundation, in 1992, and serves as its President. Mr. O'Data is listed as a finance associate in the Middle States Association, Commission on Higher Education. The commission is the formal accrediting body for higher education in the eastern region of the country. In this capacity he evaluates the financial aspects of educational organizations. Mr. O'Data is a graduate of Geneva College, where he received a B.S. degree in Economics in 1958.

Ronald G. Lehman, has been a Director of Fonar since April, 2012, when he was unanimously appointed by the remaining four Directors to fill the vacancy resulting from the death of former Director Robert Djerejian. From October, 2009 to the present, Mr. Lehman has served as Managing Director of Investment Banking with Bruderman Brothers, Inc., a private New York-based broker-dealer registered with the Securities and Exchange Commission and which is a member of the Financial Industry Regulatory Authority (FINRA) and the Securities Investor Protection Corporation (SIPC). Mr. Lehman directly manages all facets of the firm's transaction processes, from deal origination, to sourcing capital, to negotiating deal structures, through documentation and closing. The firm provides buy and sell-side advisory, capital raising, and consulting services to lower middle-market companies. Mr. Lehman specializes in advising healthcare services companies and has recently completed several recapitalizations in the industry. He also participates in the firm's merchant banking investments and oversees many of these assignments. From May, 2008 to October, 2009, Mr. Lehman served as Senior Vice President of Acquisitions at Health Diagnostics, LLC, where he managed the company's acquisition and corporate finance activities. From March, 2000 to May, 2008, Mr. Lehman



worked for various Bruderman entities as a buy and sell-side advisor and as a principal in several private equity transactions. From September, 1998 to March, 2000, Mr. Lehman worked at Deutsche Bank Securities, Inc. and last held the position of Associate in their Global Custody Group. Mr. Lehman graduated from Columbia University with a B.A. in 1998.

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## FONAR CORPORATION AND SUBSIDIARIES

## ITEM 11. EXECUTIVE COMPENSATION.

With the exception of the Chief Executive Officer, the compensation of the Company's executive officers is based on a combination of salary and bonuses based on performance. The Chief Executive Officer's compensation consists of a salary.

The Chief Executive Officer's salary varies only slightly and is by his own decision relatively low. It is not expected to increase materially in the near future. At such time as we become consistently and sufficiently profitable or there is a reconsideration of our compensation policy, the compensation payable to the Chief Executive Officer may be reconsidered. As presently existing, the Chief Executive Officer's compensation package includes no understandings with respect to bonuses, options or other incentives; as such, it is not subject to our general policy later discussed.

The Board of Directors does not have a compensation Committee. Dr. Raymond V. Damadian, President, Chief Executive Officer and Chairman of the Board, controls over 50% of the voting power of our capital stock. Dr. Damadian is both an executive officer and a member of the Board of Directors. Dr. Damadian participates in the determination of compensation for our officers and management.

The Board of Directors has established an audit committee. The members of the committee are Robert J. Janoff, Charles N. O'Data and Ronald G. Lehman.

Our compensation policy includes a combination of salary, commissions, bonuses, stock bonuses and stock options, designed to incentivize our employees. There is no universal plan applicable to all of our employees. The fixed and variable components of our employees' compensation tend to be individualized, based on a combination of the employees' performance, responsibilities and position, our assessment of how best to motivate a person in such a position and the needs and preferences of the particular employees, as negotiated between employees and their supervisors or management.

There is set forth in the following Summary Compensation Table the compensation provided by us during fiscal 2014 to our Principal Executive Officer, who also serves as our acting Principal Financial Officer. There is set forth in the following Outstanding Equity Awards Table and Director Compensation Table the required information.

## I. SUMMARY COMPENSATION TABLE

| Name and All Other Principal Position (a) | Year (b) | Salary (\$) (c) | Bonus (\$) (d) | All Other Compensation | Total Compensation |
|---|----------|-----------------|----------------|------------------------|--------------------|
| Raymond V, Damadian                       | 2014     | \$36,002.38     | —              | —                      | \$ 36,002.38       |
|   | 2013     | \$36,111.30     | —              | —                      | \$ 36,111.30       |
| PEO/PFO                                   | 2012     | \$35,934.76     | —              | —                      | \$ 35,934.76       |

## II. OUTSTANDING EQUITY AWARDS AT FISCAL YEAR-END

Name

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|                                 | Number of<br>Securities<br>Underlying<br>Unexercised<br>Options (#)<br>Exercisable | Option<br>Exercise<br>Price (\$) | Option Expiration Date<br>(c) |
|---------------------------------|--|----------------------------------|-------------------------------|
| Raymond V. Damadian,<br>PEO/PFO | (a)<br>0   | 0                                | N/A                           |

## FONAR CORPORATION AND SUBSIDIARIES

## III. DIRECTOR COMPENSATION

| Name               | Fees Earned<br>or Paid in<br>Cash (\$) | Total<br>(\$) |
|--------------------|--|---------------|
| Raymond V.Damadian | 0                                      | 0             |
| Claudette J.V.Chan | \$19,999.98                            | \$19,999.98   |
| Robert J.Janoff    | \$20,000.24                            | \$20,000.24   |
| Charles N. O'Data  | \$20,000.24                            | \$20,000.24   |
| Ronald G. Lehman   | \$19,999.98                            | \$19,999.98   |

## EMPLOYEE COMPENSATION PLANS

## Equity Compensation Plan Information as of June 30, 2012

| Plan category  | (a)<br><br>Number of<br>securities to<br>be issued<br>upon<br>exercise of<br>outstanding<br>options,<br>warrants<br>and rights | (b)<br><br>Weighted-average<br>exercise price of<br>outstanding<br>options, warrants<br>and rights | (c)<br><br>Number of<br>securities<br>remaining<br>available for<br>future<br>issuance<br>under equity<br>compensation<br>plans<br>(excluding<br>securities<br>reflected in<br>column (a)) |
|--|--|--|--|
| Equity compensation plans approved by security holders     | 14,022   | \$ 27.76   | 130,943  |
| Equity compensation plans not approved by security holders | —  | N/A  | —  |
| Total  | 14,022   | 27.76  | 130,943  |

Fonar's 2002 Incentive Stock Option Plan, adopted on July 1, 2002, was intended to qualify as an incentive stock option plan under Section 422A of the Internal Revenue Code of 1954, as amended. The 2002 Incentive Stock Option Plan permitted the issuance of stock options covering an aggregate of 100,000 shares of Common Stock of Fonar. The options issued have an exercise price equal to the fair market value of the underlying stock on the date the option was granted, are nontransferable, are exercisable for a period not exceeding ten years and expire upon the voluntary termination of employment. The 2002 Stock Option Plan terminated on June 30, 2012, and the remaining 6,610 options granted under this plan expired during the year ended June 30, 2014.

Fonar's 2005 Incentive Stock Option Plan, adopted on February 15, 2005, is intended to qualify as an incentive stock option plan under Section 422A of the Internal Revenue code of 1954, as amended. The Plan permits the issuance of stock options covering an aggregate of 80,000 shares of common stock of Fonar. The options issued have an exercise price equal to the fair market value of the underlying stock on the date the option is granted, are non-transferable, are exercisable for a period not exceeding ten years, and expire upon the voluntary termination of employment. The Plan will terminate on February 14, 2015. As of June 30, 2014, 70,000 shares of common stock of Fonar were available for future grant under this plan.

Fonar adopted its 2010 Stock Bonus Plan, on June 28, 2010. This Plan permits Fonar to issue an aggregate of 2,000,000 shares of common stock of Fonar as bonus or compensation. As of June 30, 2014, 960,033 shares were available for issuance.

## FONAR CORPORATION AND SUBSIDIARIES

## ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT.

The following table sets forth the number and percentage of shares of Fonar's securities held by each director, by each person known by us to own in excess of five percent of Fonar's voting securities and by all officers and directors as a group as of September 5, 2014.

| Name and Address of Beneficial Owner (1)  | Shares Beneficially Owned | Percent of Class |
|---|---------------------------|------------------|
| Raymond V. Damadian, M.D.<br>c/o Fonar Corporation<br>Melville, New York<br>Director, President, Treasurer<br>CEO, 5% + Stockholder |                           |                  |
| Common Stock  | 112,952                   | 1.87 %           |
| Class C Stock   | 382,447                   | 99.98 %          |
| Class A Preferred   | 19,093                    | 6.09 %           |
| Claudette Chan<br>Director and Secretary  |                           |                  |
| Common Stock  | 106                       | *                |
| Class A Preferred   | 32                        | *                |
| Robert J. Janoff<br>Director  |                           |                  |
| Common Stock  | 2,000                     | *                |
| Class A Preferred   | 79                        | *                |
| Charles N. O'Data<br>Director   |                           |                  |
| Common Stock  | 528                       | *                |
| Ronald G. Lehman<br>Director  |                           |                  |
| Common Stock  | 0                         | *                |
| All Officers and Directors as a Group (5 persons)   |                           |                  |
| Common Stock  | 115,936                   | 1.92 %           |
| Class C Stock   | 382,447                   | 99.98 %          |
| Class A Preferred   | 19,204                    | 6.13 %           |

\* Less than one percent

1. Address provided for each beneficial owner owning more than five percent of the voting securities of Fonar.

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## FONAR CORPORATION AND SUBSIDIARIES

### ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS.

#### Background.

Between 1990 and 1996, Raymond V. Damadian, M.D. MRI Scanning Centers Management Company, also referred to as "RVDC", a Delaware corporation of which Dr. Damadian was the sole stockholder, director and President, purchased and leased scanners from Fonar to establish a network of professional corporations operating MRI scanning centers, also referred to as the "Centers", in New York, Florida, Georgia and other locations. Dr. Raymond V. Damadian is the Chairman, President and principal stockholder of Fonar and was also the owner, director and President of each of these professional corporations. RVDC provided the necessary management and the scanners to the Centers, although in certain situations, a Center would acquire the scanner directly from Fonar.

#### ACQUISITION OF RVDC.

Effective June 30, 1997, Fonar's wholly-owned subsidiary, Health Management Corporation of America, also referred to as "HMCA", formerly known as U.S. Health Management Corporation, acquired RVDC by purchasing all of the issued and outstanding shares of RVDC from Dr. Damadian for 400 shares of the Common Stock of Fonar. The transactions can be rescinded by Dr. Damadian, however, in the event of a change of control in Fonar or the bankruptcy of Fonar. There is no time limit on the right to rescind. In connection with the transaction, Fonar granted RVDC a nonexclusive royalty free license to Fonar's patents and software. These licenses may be terminated by Fonar in the event of the bankruptcy of RVDC or a change in control of RVDC.

#### OTHER AGREEMENTS.

Pursuant to HMCA's management agreements with the Centers, HMCA provides to the Centers comprehensive management and administrative services, including billing and collection of accounts, payroll and accounts payable processing, office facilities, supplies and utilities. Under the management agreements, HMCA provides service for the scanners at the Centers through Fonar. In total, as of September 5, 2014, 24 MRI Centers had management agreements with HMCA.

The fees charged to the Centers under the management agreements are flat fees charged on a monthly basis. These fees ranged from \$100,000 to \$242,340 per month in fiscal 2014.

Dr. Damadian owns three of the Centers in Florida. The Centers owned by Dr. Damadian in Florida pay flat rate monthly fees ranging from \$194,050 to \$221,266 to HMCA per month. These fees are renegotiable on an annual basis.

During the fiscal years ended June 30, 2014 and June 30, 2013 the net revenues received by HMCA from the MRI Centers owned by Dr. Damadian were approximately \$9.3 million and \$7.9 million respectively.



Dr. Damadian owns a 1.667% interest in Imperial's Class A membership interests and a 1.25% interest in HDM's Class A membership interests. Dr. Damadian is also a Manager of HDM.

Timothy Damadian, a son of Dr. Damadian, is one of the owners of Trittech Healthcare Management, which performs billing and collection services with respect to No-Fault and Workers' Compensation claims of HMCA's (and HDM's) clients. The monthly fee charged to HMCA is \$30,000 and the monthly charge to HDM is \$55,000.

Bensonhurst MRI Limited Partnership, in which Timothy Damadian holds an interest, was party to an agreement with Fonar for the service and maintenance of its Upright MRI® Scanner for a price of \$110,000 per annum. Bensonhurst continues to be party to a service agreement with Fonar for \$110,000 per annum.

Integrity Healthcare Management Holdings, LLC, of which Timothy Damadian is an owner, has a 12% interest in Watchtower Entrepreneurs LLC. During fiscal 2014, Watchtower agreed to sell equipment and components to Fonar for a total of \$700,000.

## FONAR CORPORATION AND SUBSIDIARIES

Integrity Healthcare Management Holdings, LLC, also has a 14.967% interest in Imperial's Class A membership interests and a 10.000% interest in HDM's Class A membership interests.

Ronald Lehman, a Director of Fonar, holds a .0625% interest in HDM's Class A membership interests. In addition, RGL Industries, Inc., a company of which he is an owner, holds a .417% interest in Imperial's Class A membership interests.

Claudette J.V. Chan, a Director and the Secretary of Fonar, owns a .0625% interest in HDM's membership interests.

### ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES.

#### Audit Fees

The aggregate fees billed by Marcum LLP for the audit of our annual consolidated financial statements for the fiscal year ended June 30, 2014 and the reviews of the financial statements included in our Forms 10-Q for the fiscal year ended June 30, 2014 were \$628,772.

The aggregate fees billed by Marcum LLP for the audit of our annual financial statements for the fiscal year ended June 30, 2013 and the reviews of the financial statements included in our Forms 10-Q for the fiscal year ended June 30, 2013 were \$542,692.

#### Audit Related Fees

No fees were billed by Marcum LLP for the fiscal years ended June 30, 2014 or June 30, 2013 for services related to the Audit or review of our financial statements that are not included under the caption "Audit Fees".

No fees were billed by Marcum LLP for the fiscal years ended June 30, 2014 or June 30, 2013 for designing, operating, supervising or implementing any of our financial information systems or any hardware or software systems for our financial information.

#### Tax Fees

The aggregate fees billed by Marcum LLP for tax compliance, tax advice and tax planning in the fiscal year ended June 30, 2014 were \$66,580.

The aggregate fees billed by Marcum LLP for tax compliance, tax advice and tax planning in the fiscal year ended June 30, 2013 were \$147,979.

#### All Other Fees

The aggregate fees billed by Marcum LLP for all other services rendered by them during the fiscal years ended June 30, 2014 and June 30, 2013 were \$0 and \$95,929, respectively. In fiscal 2013 these services included services in connection with the registration of securities, employee benefit plan audits and reviews and procedures that we requested Marcum LLP to undertake to provide assurances on matters not required by laws or regulations.

Since January 1, 2003, the audit committee has adopted policies and procedures for pre-approving all non-audit work performed by the auditors. Specifically, the committee must pre-approve the use of the auditors for all such services. The audit committee has pre-approved all non-audit work since that time and in making its determination has considered whether the provision of such services was compatible with the independence of the auditors.

Our audit committee believes that the provision by Marcum LLP of services in addition to audit services in fiscal 2013 and 2012 were compatible with maintaining their independence.

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FONAR CORPORATION AND SUBSIDIARIES

PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K.

a) FINANCIAL STATEMENTS AND SCHEDULES

The following consolidated financial statements are included in Part II, Item 8.

Report of Independent Registered Public Accounting Firm

Consolidated Balance Sheets as at June 30, 2014 and 2013.

Consolidated Statements of Income for the Years Ended June 30, 2014 and 2013.

Consolidated Statements of Stockholders' Equity for the Years Ended June 30, 2014 and 2013.

Consolidated Statements of Cash Flows for the Years Ended June 30, 2014 and 2013.

Notes to Consolidated Financial Statements.

Information required by schedules called for under Regulation S-X is either not applicable or is included in the consolidated financial statements or notes to the financial statements.

b) REPORTS ON FORM 8-K

1. Registrant's Report on Form 8-K containing the

Company's Earnings Report for the first nine months of Fiscal 2014. May 15, 2014. Commission File No. 0-10248.

2. Registrant's Report on Form 8-K reporting the results of the election of directors and selection of auditors at the annual meeting of stockholders. June 24, 2014. Commission File No. 0-10248.

c) EXHIBITS

3.1 Certificate of Incorporation, as amended, of the Registrant incorporated by reference to Exhibit 3.1 to the Registrant's registration statement on Form S-1, Commission File No. 33-13365.

3.2 Article Fourth of the Certificate of Incorporation, as amended, of the Registrant incorporated by reference to Exhibit 4.1 to the Registrant's registration statement on Form S-8, Commission File No. 33-62099.

3.3 Section A of Article Fourth of the Certificate of Incorporation, as amended, of the Registrant incorporated by reference to Exhibit 4.3 to the Registrant's registration statement on Form S-3, Commission File No. 333-63782.

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3.4 Section A of Article Fourth of the Certificate of Incorporation, as amended, of the Registrant incorporated by reference to Exhibit 3.3 of the Registrant's Annual Report on Form 10-K for the fiscal year ended June 30, 2003, Commission File No. 0-10248.

3.5 By-Laws, as amended, of the Registrant incorporated by reference to Exhibit 3.2 to the Registrant's registration statement on Form S-1, Commission File No. 33-13365.

4.1 Specimen Common Stock Certificate incorporated by reference to Exhibit 4.1 to the Registrant's registration statement on Form S-1, Commission File No. 33-13365.

4.2 Specimen Class B Common Stock Certificate incorporated by reference to Exhibit 4.2 to the Registrant's registration statement on Form S-1, Commission File No. 33-13365.

4.3 Form of 4% Convertible Debentures due June 30, 2002 incorporated by reference to Exhibit 4.1 of the Registrant's current report on Form 8-K filed on June 11, 2001. Commission File No. 0-10248.

4.4 Form of Purchase Warrants incorporated by reference to Exhibit 4.2 of the Registrant's current report on Form 8-K filed on June 11, 2001. Commission File No. 0-10248.

4.5 Form of Callable Warrants incorporated by reference to Exhibit 4.3 of the Registrant's current report on Form 8-K filed on June 11, 2001. Commission File No. 0-10248.

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FONAR CORPORATION AND SUBSIDIARIES

4.6 Form of Replacement Callable Warrants incorporated by reference to Exhibit 4.7 of the Registrant's registration statement on Form S-3, Commission File No. 333-10677.

4.7 Form of Amended and Restated Purchase Warrant for The Tail Wind Fund, Ltd. incorporated by reference to Exhibit 4.7 of the Registrants registration statement on Form S-3, Commission File No. 333-116908.

4.8 Form of Amended and Restated Purchase Warrant for Placement Agent and Designees incorporated by reference to Exhibit 4.8 of the Registrant's registration statement on Form S-3, Commission File No. 333-116908.

10.1 License Agreement between the Registrant and Raymond V. Damadian incorporated by reference to Exhibit 10 (e) to Form 10-K for the fiscal year ended June 30, 1983, Commission File No. 0-10248.

10.2 1983 Nonstatutory Stock Option Plan incorporated by reference to Exhibit 10 (a) to Form 10-K for the fiscal year ended June 30, 1983, Commission File No. 0-10248, and amendments thereto dated as of March 7, 1984 and dated August 22, 1984, incorporated by referenced to Exhibit 28 (a) to Form 10-K for the year ended June 30, 1984, Commission File No. 0-10248.

10.3 1984 Incentive Stock Option Plan incorporated by reference to Exhibit 28 (c) to Form 10-K for the year ended June 30, 1984, Commission File No. 0-10248.

10.4 1986 Nonstatutory Stock Option Plan incorporated by reference to Exhibit 10.7 to Form 10-K for the fiscal year ended June 30, 1986, Commission File No. 0-10248.

10.5 1986 Stock Bonus Plan incorporated by reference to Exhibit 10.8 to Form 10-K for the fiscal year ended June 30, 1986, Commission File No. 0-10248.

10.6 1986 Incentive Stock Option Plan incorporated by reference to Exhibit 10.9 to Form 10-K for the fiscal year ended June 30, 1986, Commission File No. 0-10248.

10.7 Lease Agreement, dated as of August 18, 1987, between the Registrant and Reckson Associates incorporated by reference to Exhibit 10.26 to Form 10-K for the fiscal year ended June 30, 1987, Commission File No. 0-10248.

10.8 1993 Incentive Stock Option Plan incorporated by reference to Exhibit 28.1 to the Registrant's registration statement on Form S-8, Commission File No. 33-60154.

10.9 1993 Non-Statutory Stock Option Plan incorporated by reference to Exhibit 28.2 to the Registrant's registration statement on Form S-8, Commission File No. 33-60154.

10.10 1993 Stock Bonus Plan incorporated by reference to Exhibit 28.3 to the Registrant's registration statement on Form S-8, Commission File No. 33-60154.

10.11 1994 Non-Statutory Stock Option Plan incorporated by reference to Exhibit 28.1 to the Registrant's registration statement on Form S-8, Commission File No. 33-81638.

10.12 1994 Stock Bonus Plan incorporated by reference to Exhibit 28.2 to the Registrant's registration statement on Form S-8, Commission File No. 33-81638.

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10.13 1995 Non-Statutory Stock Option Plan incorporated by reference to Exhibit 28.1 to the Registrant's registration statement on Form S-8, Commission File No. 33-62099.

10.14 1995 Stock Bonus Plan incorporated by reference to Exhibit 28.2 to the Registrant's registration statement on Form S-8, Commission File No. 33-62099.

10.15 1997 Non-Statutory Stock Option Plan incorporated by reference to Exhibit 28.1 to the Registrant's registration statement on Form S-8, Commission File No.: 333-27411.

10.16 1997 Stock Bonus Plan incorporated by reference to Exhibit 28.2 to the Registrant's registration statement on Form S-8, Commission File No: 333-27411.

10.17 Stock Purchase Agreement, dated July 31, 1997, by and between U.S. Health Management Corporation, Raymond V. Damadian, M.D. MR Scanning Centers Management Company and Raymond V. Damadian, incorporated by reference to Exhibit 2.1 to the Registrant's Form 8-K, July 31, 1997, commission File No: 0-10248.

FONAR CORPORATION AND SUBSIDIARIES

10.18 Merger Agreement and Supplemental Agreement dated June 17, 1997 and Letter of Amendment dated June 27, 1997 by and among U.S. Health Management Corporation and Affordable Diagnostics Inc. et al., incorporated by reference to Exhibit 2.1 to the Registrant's 8-K, June 30, 1997, Commission File No: 0-10248.

10.19 Stock Purchase Agreement dated March 20, 1998 by and among Health Management Corporation of America, Fonar Corporation, Giovanni Marciano, Glenn Muraca et al., incorporated by reference to Exhibit 2.1 to the Registrant's 8-K, March 20, 1998, Commission File No: 0-10248.

10.20 Stock Purchase Agreement dated August 20, 1998 by and among Health Management Corporation of America, Fonar Corporation, Stuart Blumberg and Steven Jonas, incorporated by reference to Exhibit 2 to the Registrant's 8-K, September 3, 1998, Commission File No. 0-10248.

10.21 2000 Stock Bonus Plan incorporated by reference to Exhibit 99.1 to the Registrant's registration Statement on Form S-8, Commission File No.: 333-66760.

10.22 2002 Stock Bonus Plan incorporated by reference to Exhibit 99.1 to the Registrant's registration statement on Form S-8, Commission File No.: 333-89578.

10.23 2002 Incentive Stock Option Plan incorporated by reference to Exhibit 99.1 to the Registrant's registration statement on Form S-8, Commission File No.: 333-96557.

10.24 2003 Stock Bonus Plan incorporated by reference to Exhibit 99.1 to the Registrant's registration statement on Form S-8, Commission File No: 333-106626.

10.25 2003 Supplemental Stock Bonus Plan incorporated by reference to Exhibit 99.1 to the Registrant's registration statement on Form S-8, Commission File No: 333-106626.

10.26 2004 Stock Bonus Plan incorporated by reference to Exhibit 99.1 to the Registrant's registration statement on Form S-8, Commission File No. 333-112577.

10.27 2005 Stock Bonus Plan incorporated by reference to Exhibit 99.1 to the Registrant's registration statement on Form S-8, Commission File No. 333-122859.

10.28 2005 Supplemental Stock Bonus Plan incorporated by reference to Exhibit 99.1 to the Registrant's registration statement on Form S-8, Commission File No. 333-126658.

10.29 Purchase Agreement dated May 24, 2001 by and between the Registrant and The Tail Wind Fund Ltd. incorporated by reference to Exhibit 10.1 to the Registrant's current report on Form 8-K filed June 11, 2001. Commission File No. 0-10248.

10.30 Registration Rights Agreement dated May 24, 2001 by and among the Registrant, The Tail Wind Fund Ltd. and Roan Meyers, Inc. incorporated herein by reference to Exhibit 10.2 to the Registrant's current report on Form 8-K filed June 11, 2001. Commission File No. 0-10248.



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10.31 Amendment to Callable Warrant dated April 28, 2004 by and between The Tail Wind Fund, Ltd. and the Registrant incorporated by reference to Exhibit 10.17 to the Registrant's registration statement on Form S-3, Commission File No. 333-116908.

10.32 First Amendment to Purchase Warrant dated April 28, 2004 by and between The Tail Wind Fund, Ltd. and the Registrant incorporated by reference to Exhibit 10.18 to the Registrant's registration statement on Form S-3, Commission File No. 333-116908.

10.33 Form of First Amendment to Purchase Warrant dated June 1, 2004 by and between each of Roan/Meyers Associates, L.P. and its designees and the Registrant, incorporated by reference to Exhibit 10.19 to the Registrant's registration statement on Form S-3, Commission File No. 333-116908.

10.34 Asset Purchase Agreement dated July 28, 2005 among Health Plus Management Services, L.L.C., Health Management Corporation of America, Dynamic Healthcare Management, Inc. and Fonar Corporation, incorporated by reference to Exhibit 2 to the Registrant's Form 8-K, August 2, 2005, Commission File No. 0-10248.

10.35 Partnership Interest Purchase Agreement dated September 29, 2008 by and between Diagnostic Management, LLC and Raymond V. Damadian, M.D. MR Scanning Centers Management Company, incorporated by reference to Exhibit 10.35 to Form 10-K for the fiscal year ended June 30, 2008. Commission File No. 0-10248.

10.36 2010 Stock Bonus Plan, incorporated by reference to Exhibit 99.1 to the Registrant's registration statement on Form S-8, Commission File No. 333-168771.

FONAR CORPORATION AND SUBSIDIARIES

10.37 Operating Agreement for Imperial Management Services, LLC, incorporated by reference to Exhibit 10.37 to Form 10-K for the fiscal year ended June 30, 2011. Commission File No. 0-10248.

10.38 Operating Agreement for Health Diagnostics Management, LLC, incorporated by reference to Exhibit 10.38 to Form 10-K for the fiscal year ended June 30, 2013. Commission File No. 0-10248. 10.39 Modification to Operating Agreement for Health Diagnostics Management, LLC. See Exhibits.

10.40 Purchase Agreement dated March 5, 2013 among Health Diagnostics Management, LLC, Health Diagnostics, LLC and others. Incorporated by reference to Exhibit 10.1 to the Registrant's Form 8-K filed March 11, 2013. Commission File No. 0-10248.

14.1 Code of Ethics, incorporated by reference to Exhibit 14.1 of Registrant's Form 10-K for the fiscal year ended June 30, 2004, Commission File No.: 0-10248.

21.1 Subsidiaries of the Registrant. See Exhibits.

23.1 Independent Registered Public Accounting Firm's Report See Exhibits.

31.1 Section 302 Certification. See Exhibits.

32.1 Section 906 Certification. See Exhibits.

SIGNATURES

Pursuant to the requirements of Section 13 or 15 (d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Dated: September 29, 2014

By:/s/Raymond V. Damadian

Raymond V. Damadian, President

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

| Signature | Title | Date |
|-----------|-------|------|
|-----------|-------|------|

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|--|---|-----------------------|
| /s/Raymond V. Damadian<br>Raymond V. Damadian, | Chairman of the Board of Directors, President, Director Principal<br>Executive Officer and Acting Principal Financial Officer | September 29,<br>2014 |
| /s/Claudette J.V. Chan<br>Claudette J.V. Chan  | Director  | September 29,<br>2014 |
| /s/ Robert J. Janoff<br>Robert J. Janoff       | Director  | September 29,<br>2014 |
| /s/ Charles N. O'Data<br>Charles N. O'Data     | Director  | September 29,<br>2014 |
| /s/Ronald G. Lehman<br>Ronald G. Lehman        | Director  | September 29,<br>2014 |

