AeroVironment Inc
Form 10-Q
March 08, 2017
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.

For the quarterly period ended January 28, 2017

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from to

Commission File Number: 001-33261

AEROVIRONMENT, INC.

(Exact name of registrant as specified in its charter)

Delaware	95-2705790
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
800 Royal Oaks Drive, Suite 210 Monrovia, California	91016
(Address of principal executive offices)	(Zip Code)

(626) 357-9983

(Registrant’s telephone number, including area code)

N/A

(Former name, former address and former fiscal year, if changed since last report)

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer

Non-accelerated filer (Do not check if 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

As of February 28, 2017, the number of shares outstanding of the registrant's common stock, $0.0001 par value, was 23,455,347.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

AeroVironment, Inc.

Consolidated Balance Sheets

(In thousands except share and per share data)

	January 28, 2017 (Unaudited)	April 30, 2016
Assets		
Current assets:		
Cash and cash equivalents	$ 73,278	$ 124,287
Short-term investments	121,095	103,404
Accounts receivable, net of allowance for doubtful accounts of $375 at January 28, 2017 and $262 at April 30, 2016	23,121	56,045
Unbilled receivables and retentions	14,820	18,899
Inventories, net	68,806	37,486
Income tax receivable	2,487	—
Prepaid expenses and other current assets	5,341	4,150
Total current assets	308,948	344,271
Long-term investments	43,749	33,859
Property and equipment, net	18,410	16,762
Deferred income taxes	15,779	15,016
Other assets	570	750
Total assets	$ 387,456	$ 410,658
Liabilities and stockholders’ equity		
Current liabilities:		
Accounts payable	$ 13,792	$ 17,712
Wages and related accruals	10,967	13,973
Income taxes payable	—	943
Customer advances	5,456	2,544
Other current liabilities	7,753	11,173
Total current liabilities	37,968	46,345
Deferred rent	1,769	1,714
Capital lease obligations - net of current portion	218	449
Other non-current liabilities	193	184
Liability for uncertain tax positions	62	441
Commitments and contingencies		
Stockholders’ equity:		
Preferred stock, $0.0001 par value:		

Authorized shares—10,000,000; none issued or outstanding at January 28, 2017 and April 30, 2016	—	—
Common stock, $0.0001 par value:		
Authorized shares—100,000,000		
Issued and outstanding shares—23,456,561 shares at January 28, 2017 and 23,359,925 at April 30, 2016	2	2
Additional paid-in capital	157,960	154,274
Accumulated other comprehensive loss	(169)	(201)
Retained earnings	189,453	207,450
Total stockholders' equity	347,246	361,525
Total liabilities and stockholders' equity	$ 387,456	$ 410,658

See accompanying notes to consolidated financial statements (unaudited).

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AeroVironment, Inc.

Consolidated Statements of Operations (Unaudited)

(In thousands except share and per share data)

	Three Months Ended		Nine Months Ended	
	January 28, 2017	January 30, 2016	January 28, 2017	January 30, 2016
Revenue:				
Product sales	$ 36,746	$ 53,305	$ 81,833	$ 129,436
Contract services	16,417	14,255	57,664	49,905
	53,163	67,560	139,497	179,341
Cost of sales:				
Product sales	23,641	31,910	58,060	73,477
Contract services	10,171	9,025	37,986	31,683
	33,812	40,935	96,046	105,160
Gross margin:				
Product sales	13,105	21,395	23,773	55,959
Contract services	6,246	5,230	19,678	18,222
	19,351	26,625	43,451	74,181
Selling, general and administrative	12,788	13,313	39,838	43,302
Research and development	7,988	8,247	25,105	27,975
(Loss) income from operations	(1,425)	5,065	(21,492)	2,904
Other income (expense):				
Interest income, net	390	181	1,162	673
Other expense, net	(46)	(215)	(476)	(2,796)
(Loss) income before income taxes	(1,081)	5,031	(20,806)	781
Provision (benefit) for income taxes	1,102	(1,133)	(2,809)	(2,821)
Net (loss) income	$ (2,183)	$ 6,164	$ (17,997)	$ 3,602
(Loss) earnings per share data:				
Basic	$ (0.09)	$ 0.27	$ (0.78)	$ 0.16
Diluted	$ (0.09)	$ 0.27	$ (0.78)	$ 0.16
Weighted average shares outstanding:				
Basic	23,082,974	22,890,484	23,029,546	22,941,354
Diluted	23,082,974	23,083,816	23,029,546	23,139,981

See accompanying notes to consolidated financial statements (unaudited).

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AeroVironment, Inc.

Consolidated Statements of Comprehensive (Loss) Income (Unaudited)

(In thousands)

	Three Months Ended		Nine Months Ended	
	January 28, 2017	January 30, 2016	January 28, 2017	January 30, 2016
Net (loss) income	$ (2,183)	$ 6,164	$ (17,997)	$ 3,602
Other comprehensive (loss) income:				
Unrealized (loss) gain on investments, net of deferred tax (benefit) expense of $(23) and $5 for the three months ended January 28, 2017 and January 30, 2016, respectively; and net of deferred tax expense of $6 and $23 for the nine months ended January 28, 2017 and January 30, 2016, respectively	(11)	7	32	34
Total comprehensive (loss) income	$ (2,194)	$ 6,171	$ (17,965)	$ 3,636

See accompanying notes to consolidated financial statements (unaudited).

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AeroVironment, Inc.

Consolidated Statements of Cash Flows (Unaudited)

(In thousands)

	Nine Months Ended	
	January 28, 2017	January 30, 2016
Operating activities		
Net (loss) income	$ (17,997)	$ 3,602
Adjustments to reconcile net loss to cash used in operating activities:		
Depreciation and amortization	5,188	4,547
Loss from equity method investments	119	248
Impairment of available-for-sale securities	—	2,186
Provision for doubtful accounts	115	(252)
Losses on foreign currency transactions	272	63
Loss on sale of equity securities	—	219
Deferred income taxes	(698)	18
Stock-based compensation	2,736	3,170
Tax benefit from exercise of stock options	22	302
Loss (gain) on disposition of property and equipment	37	(32)
Amortization of held-to-maturity investments	1,827	3,086
Changes in operating assets and liabilities:		
Accounts receivable	32,553	(5,052)
Unbilled receivables and retentions	4,079	6,916
Inventories	(31,320)	(7,020)
Income tax receivable	(2,487)	(3,952)
Prepaid expenses and other assets	(1,190)	455
Accounts payable	(3,170)	(9,457)
Other liabilities	(4,510)	(4,746)
Net cash used in operating activities	(14,424)	(5,699)
Investing activities		
Acquisition of property and equipment	(7,586)	(4,259)
Equity method investment	—	(295)
Redemptions of held-to-maturity investments	93,208	67,402
Purchases of held-to-maturity investments	(122,978)	(75,740)
Proceeds from the sale of property and equipment	7	—
Sales and redemptions of available-for-sale investments	400	987
Net cash used in investing activities	(36,949)	(11,905)
Financing activities		
Purchase and retirement of common stock	—	(3,756)
Principal payments of capital lease obligations	(291)	(341)
Tax withholding payment related to net settlement of equity awards	—	(29)
Exercise of stock options	655	1,026
Net cash provided by (used in) financing activities	364	(3,100)
Net decrease in cash and cash equivalents	(51,009)	(20,704)
Cash and cash equivalents at beginning of period	124,287	143,410

Cash and cash equivalents at end of period	$ 73,278	$ 122,706
Supplemental disclosures of cash flow information		
Cash paid during the period for:		
Income taxes	$ 1,786	$ 1,539
Non-cash activities		
Unrealized change in fair value of long-term investments recorded in accumulated other comprehensive loss, net of deferred tax expense of $6 and $23, respectively	$ 32	$ 34
Reclassification from share-based liability compensation to equity	$ 307	$ 228
Acquisitions of property and equipment financed with capital lease obligations	$ —	$ 694
Acquisitions of property and equipment included in accounts payable	$ 408	$ —

See accompanying notes to consolidated financial statements (unaudited).

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AeroVironment, Inc.

Notes to Consolidated Financial Statements (Unaudited)

1. Organization and Significant Accounting Policies

Organization

AeroVironment, Inc., a Delaware corporation (the “Company”), is engaged in the design, development, production, support and operation of unmanned aircraft systems (“UAS”) and efficient energy systems (“EES”) for various industries and governmental agencies.

Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (“U.S. GAAP”) for interim financial information and with the instructions of Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. In the opinion of management, all adjustments, consisting only of normal recurring adjustments necessary for a fair presentation with respect to the interim financial statements have been included. The results of operations for the three and nine months ended January 28, 2017, are not necessarily indicative of the results for the full year ending April 30, 2017. For further information, refer to the consolidated financial statements and footnotes thereto for the year ended April 30, 2016, included in the Company’s Annual Report on Form 10-K.

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions, including estimates of anticipated contract costs and revenue utilized in the revenue recognition process, that affect the reported amounts in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates.

The Company’s consolidated financial statements include the assets, liabilities and operating results of wholly-owned subsidiaries. All intercompany accounts and transactions have been eliminated.

In July 2016, the Company dissolved Charger Bicycles, LLC, the results of which were not material to the consolidated financial statements. During the three months ended October 29, 2016, the Company dissolved Skytower, LLC and Regenerative Fuel Cell Systems, LLC, the results of which were not material to the consolidated financial statements.

Recently Adopted Accounting Standards

In November 2015, the Financial Accounting Standards Board ("FASB") issued Accounting Standard Update ("ASU") No. 2015-17, Balance Sheet Classification of Deferred Taxes, which requires entities to present deferred tax assets and liabilities as noncurrent in a classified balance sheet. This guidance simplifies the current guidance, which requires entities to separately present deferred tax assets and liabilities as current and non-current in a classified balance sheet. ASU 2015-17 is effective for fiscal years beginning after December 15, 2016, and interim periods within those years, with early adoption permitted. The ASU may be applied either prospectively to all deferred tax assets and liabilities or retrospectively to all periods presented. The Company adopted this pronouncement beginning May 1, 2016 and applied this pronouncement retrospectively. In connection with adopting the pronouncement beginning May 1, 2016, the Company reclassified $5,432,000 from current deferred income tax assets in the consolidated balance sheet as of April 30, 2016 to non-current deferred income tax liabilities.

In March 2016, the FASB issued ASU No. 2016-09, Compensation—Stock Compensation (Topic 718), Improvements to Employee Share-Based Payment Accounting. The new standard simplifies the accounting for employee share-based payment transactions, including the accounting for income taxes, forfeitures, and statutory withholding requirements, as well as the related classification in the statement of cash flows. The new standard is effective for annual reporting periods beginning after December 15, 2016, and interim periods within those years, with early adoption permitted. The standard requires an entity to recognize all excess tax benefits and tax deficiencies as income tax benefit or expense in

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the income statement as discrete items in the reporting period in which they occur, and such tax benefits and tax deficiencies are not included in the estimate of an entity's annual effective tax rate, applied on a prospective basis. Further, the standard eliminates the requirement to defer the recognition of excess tax benefits until the benefit is realized through a reduction to taxes payable. All excess tax benefits previously unrecognized, along with any valuation allowance, are to be recognized on a modified retrospective basis as a cumulative adjustment to retained earnings as of the date of adoption. Under the ASU, an entity that applies the treasury stock method in calculating diluted earnings per share is required to exclude excess tax benefits and deficiencies from the calculation of assumed proceeds since such amounts are recognized in the income statement. Excess tax benefits are also classified as operating activities in the same manner as other cash flows related to income taxes on the statement of cash flows, as such excess tax benefits no longer represent financing activities since they are recognized in the income statement, and are to be applied prospectively or retrospectively to all periods presented. The Company adopted the pronouncement beginning May 1, 2016. In connection with adopting the pronouncement beginning May 1, 2016, the Company recorded a cumulative increase of $265,000 in retained earnings with a corresponding increase in deferred tax assets in the consolidated balance sheet as of April 30, 2016 related to the prior years' unrecognized excess tax benefits. Excess tax benefits related to exercised options and vested restricted stock awards during the three months ended July 30, 2016 have been recognized in the current period's income statement. The Company also excluded the excess tax benefits from the calculation of diluted earnings per share for the three months ended July 30, 2016. The Company applied the cash flow presentation section of the guidance on a prospective basis, and the prior period statement of cash flows was not adjusted.

Reclassifications

Certain prior year amounts have been reclassified to conform to the current year presentation related to the adoption of new accounting pronouncements during the nine months ended January 28, 2017 impacting the classification of deferred income taxes in the consolidated balance sheets.

Segments

The Company's products are sold and divided among two reportable segments to reflect the Company's strategic goals. Operating segments are defined as components of an enterprise from which separate financial information is available that is evaluated regularly by the Chief Operating Decision Maker ("CODM") in deciding how to allocate resources and in assessing performance. The Company's CODM is the Chief Executive Officer, who reviews the revenue and gross margin results for each of these segments in order to make resource allocation decisions, including the focus of research and development ("R&D") activities and performance assessment. The Company's reportable segments are business units that offer different products and services and are managed separately.

Investments

The Company’s investments are accounted for as held-to-maturity and available-for-sale and reported at amortized cost and fair value, respectively.

Fair Values of Financial Instruments

Fair values of cash and cash equivalents, accounts receivable, unbilled receivables, retentions and accounts payable approximate cost due to the short period of time to maturity.

Government Contracts

Payments to the Company on government cost reimbursable contracts are based on provisional, or estimated indirect rates, which are subject to an annual audit by the Defense Contract Audit Agency (“DCAA”). The cost audits result in the negotiation and determination of the final indirect cost rates that the Company may use for the period(s) audited. The final rates, if different from the provisional rates, may create an additional receivable or liability for the Company.

For example, during the course of its audits, the DCAA may question the Company’s incurred costs, and if the DCAA

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believes the Company has accounted for such costs in a manner inconsistent with the requirements under Federal Acquisition Regulations, the DCAA auditor may recommend to the Company's administrative contracting officer to disallow such costs. Historically, the Company has not experienced material disallowed costs as a result of government audits. However, the Company can provide no assurance that the DCAA or other government audits will not result in material disallowances for incurred costs in the future.

The Company's revenue recognition policy calls for revenue recognized on all cost reimbursable government contracts to be recorded at actual rates unless collectability is not reasonably assured.

The Defense Contract Management Agency, or DCMA, disallowed a portion of the Company's executive compensation and/or other costs included in the Company's fiscal 2006, 2007 and 2008 incurred cost claims and sought interest for all three years and penalties for Fiscal 2006, based on the disallowed costs. The Company appealed these cost disallowances to the Armed Services Board of Contract Appeals. For Fiscal 2006, as a result of partial settlements and a decision of the Armed Services Board of Contract Appeals in March 2016, the government's remaining claims were dismissed with prejudice. All of the government's claims related to the Company's 2007 and 2008 incurred cost claims were settled as of October 2015 by payment to the government of $50,000 and the government's claims related to the Company's 2009 and 2010 incurred cost claims were settled as of October 2015 and April 2016, respectively, without the payment of any consideration.

As a result of the settlement agreements and the Armed Services Board of Contract Appeals ruling, the Company reversed reserves of $3,607,000 related to those fiscal years as a credit to cost of sales, allocated as $3,203,000 to the UAS segment and $404,000 to the EES segment during the fiscal year ended April 30, 2016. At January 28, 2017 and April 30, 2016, the Company did not have any remaining reserves for incurred cost claim audits.

(Loss) Earnings Per Share

Basic (loss) earnings per share is computed using the weighted-average number of common shares outstanding, excluding shares of unvested restricted stock.

The reconciliation of basic to diluted shares is as follows:

	Three Months Ended		Nine Months Ended	
	January 28, 2017	January 30, 2016	January 28, 2017	January 30, 2016

Denominator for basic (loss) earnings per share:				
Weighted average common shares outstanding, excluding unvested restricted stock	23,082,974	22,890,484	23,029,546	22,941,354
Dilutive effect of employee stock options and unvested restricted stock	—	193,332	—	198,627
Denominator for diluted (loss) earnings per share	23,082,974	23,083,816	23,029,546	23,139,981

Due to the net loss for the three and nine months ended January 28, 2017, no shares reserved for issuance upon exercise of stock options or shares of unvested restricted stock were included in the computation of diluted loss per share as their inclusion would have been anti-dilutive. Potentially dilutive shares not included in the computation of diluted weighted average common shares because their effect would have been antidilutive were 222,071 and 246,903 for the three and nine months ended January 28, 2017, respectively. During the three and nine months ended January 30, 2016, shares reserved for issuance upon exercise of stock options and shares of unvested restricted stock not included in the computation of diluted earnings per share because their inclusion would have been anti-dilutive were approximately 9,000 and 40,000, respectively.

Recently Issued Accounting Standards

In January 2017, the FASB issued ASU 2017-01, Business Combinations – Clarifying the definition of a business (Topic 805). This ASU clarifies the definition of a business with the objective of providing a more robust framework to evaluate whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. The guidance will be effective for fiscal years beginning after December 15, 2017, including interim periods within that fiscal year, with early adoption permitted. The amendments are to be applied prospectively to business combinations that occur after the effective date.

In August 2016, the FASB issued ASU 2016-15, Statement of Cash Flows - Classification of Certain Cash Receipts and Cash Payments (Topic 230). This ASU adds and clarifies guidance on the classification of certain cash receipts and payments in the statement of cash flows. The guidance is effective for fiscal years beginning after December 15, 2017 and interim periods therein, with early adoption permitted. The Company is evaluating the potential impact of this adoption on its consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842). This ASU requires the lessee to recognize the assets and liabilities for the rights and obligations created by leases with terms of 12 months or more. The guidance is effective for fiscal years beginning after December 15, 2018 and interim periods therein, with early adoption permitted. The Company is evaluating the potential impact of this adoption on its consolidated financial statements.

In July 2015, the FASB issued ASU No. 2015-11, Inventory (Topic 330): Simplifying the Measurement of Inventory. This ASU does not apply to inventory that is measured using last-in, first-out (LIFO) or the retail inventory method. The amendments apply to all other inventory, which includes inventory that is measured using first-in, first-out (FIFO) or average cost. This ASU eliminates from U.S. GAAP the requirement to measure inventory at the lower of cost or market. Market under the previous requirement could be replacement cost, net realizable value, or net realizable value less a normal profit margin. Entities within the scope of this update will now be required to measure inventory at the lower of cost and net realizable value. Net realizable value is the estimated selling price in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. Subsequent measurement is unchanged for inventory using LIFO or the retail inventory method. The amendments in this update are effective for fiscal years beginning after December 15, 2016, with early adoption permitted. The Company is evaluating the potential impact of this adoption on its consolidated financial statements.

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606). The new standard was originally effective for reporting periods beginning after December 15, 2016 and early adoption was not permitted. In August 2015, the FASB issued ASU No. 2015-14, Revenue from Contracts with Customers (Topic 640)-Deferral of the Effective Date. This update approved a one year delay of the effective date to reporting periods beginning after December 15, 2017, while permitting companies to voluntarily adopt the new standard as of the original effective date. Since the issuance of ASU 2014-09, the FASB has issued several amendments to provide additional supplemental guidance on certain aspects of the original pronouncement. The core principle of ASU 2014-09 is to recognize revenue upon the transfer of goods or services to customers at an amount that reflects the consideration expected to be received. In adopting the guidance, companies are permitted to select between two transition methods: (1) a full retrospective transition method with the application of the new guidance to each prior reporting period presented, or (2) a retrospective transition method that recognizes the cumulative effect on prior periods at the date of adoption together with additional footnote disclosures. The Company is continuing to assess the potential impact of this guidance, including the impact on those areas currently subject to industry-specific guidance such as government contract accounting. As part of its assessment, the Company is reviewing representative samples of customer contracts to determine the impact on revenue recognition under the new guidance. At this time, the Company anticipates adopting the guidance under the retrospective transition method.

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2. Investments

Investments consist of the following (in thousands):

	January 28, 2017	April 30, 2016
Short-term investments:		
Held-to-maturity securities:		
Municipal securities	$ 40,211	$ 42,179
U.S. government securities	19,720	21,184
Corporate bonds	56,664	40,041
Certificates of deposit	4,500	—
Total held-to-maturity and short-term investments	$ 121,095	$ 103,404
Long-term investments:		
Held-to-maturity securities:		
Municipal securities	$ 15,446	$ —
U.S. government securities	15,549	7,518
Corporate bonds	10,336	23,561
Total held-to-maturity investments	41,331	31,079
Available-for-sale securities:		
Auction rate securities	2,418	2,780
Total available-for-sale investments	2,418	2,780
Total long-term investments	$ 43,749	$ 33,859

Held-To-Maturity Securities

As of January 28, 2017 and April 30, 2016, the balance of held-to-maturity securities consisted of state and local government municipal securities, U.S. treasury and agency securities, certificates of deposit and corporate bonds. Interest earned from these investments is recorded in interest income.

The amortized cost, gross unrealized gains, gross unrealized losses, and estimated fair value of the held-to-maturity investments as of January 28, 2017, were as follows (in thousands):

	Amortized	Gross Unrealized	Gross Unrealized	Fair

	Cost	Gains	Losses	Value
Municipal securities	$ 55,657	$ 25	$ (43)	$ 55,639
U.S. government securities	35,269	5	(13)	35,261
Corporate bonds	67,000	2	(113)	66,889
Certificates of deposit	4,500	3	—	4,503
Total held-to-maturity investments	$ 162,426	$ 35	$ (169)	$ 162,292

The amortized cost, gross unrealized gains, gross unrealized losses, and estimated fair value of the held-to-maturity investments as of April 30, 2016, were as follows (in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Municipal securities	$ 42,179	$ 5	$ (7)	$ 42,177
U.S. government securities	28,702	23	—	28,725
Corporate bonds	63,602	54	(32)	63,624
Certificates of deposit	—	—	—	—
Total held-to-maturity investments	$ 134,483	$ 82	$ (39)	$ 134,526

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The amortized cost and fair value of the held-to-maturity securities by contractual maturity at January 28, 2017, were as follows (in thousands):

	Cost	Fair Value
Due within one year	$ 121,095	$ 121,031
Due after one year through five years	41,331	41,261
Total	$ 162,426	$ 162,292

Available-For-Sale Securities

Auction Rate Securities

As of January 28, 2017 and April 30, 2016, the entire balance of available-for-sale, auction rate securities, consisted of two investment grade auction rate municipal bonds, with maturities of approximately 2 and 17 years, respectively. These investments have characteristics similar to short-term investments, because at pre-determined intervals, generally ranging from 30 to 35 days, there is a new auction process at which the interest rates for these securities are reset to current interest rates. At the end of such period, the Company chooses to roll-over its holdings or redeem the investments for cash. A market maker facilitates the redemption of the securities and the underlying issuers are not required to redeem the investment within 365 days. Interest earned from these investments is recorded in interest income.

During the fourth quarter of the fiscal year ended April 30, 2008, the Company began experiencing failed auctions on some of its auction rate securities. A failed auction occurs when a buyer for the securities cannot be obtained and the market maker does not buy the security for its own account. The Company continues to earn interest on the investments that failed to settle at auction, at the maximum contractual rate until the next auction occurs. In the event the Company needs to access funds invested in these auction rate securities, the Company may not be able to liquidate these securities at the fair value recorded on January 28, 2017, until a future auction of these securities is successful or a buyer is found outside of the auction process.

As a result of the failed auctions, the fair values of these securities are estimated utilizing a discounted cash flow analysis as of January 28, 2017. The analysis considers, among other items, the collateralization underlying the security investments, the creditworthiness of the counterparty, the timing of expected future cash flows, and the estimated date upon which the security is expected to have a successful auction. Based on the Company’s ability to access its cash and cash equivalents, expected operating cash flows, and other sources of cash, the Company does not anticipate that the current lack of liquidity of these investments will affect its ability to operate its business in the ordinary course. The Company believes the current lack of liquidity of these investments is temporary and expects that the securities will be redeemed or refinanced at some point in the future. The Company will continue to monitor the value of its auction rate securities at each reporting period for a possible impairment if a further decline in fair value occurs. The auction rate securities have been in an unrealized loss position for more than 12 months. The Company has the ability and the intent to hold these investments until a recovery of fair value, which may be at maturity and as of January 28, 2017, the Company did not consider these investments to be other-than-temporarily impaired.

The amortized cost, gross unrealized gains, gross unrealized losses, and estimated fair value of the auction rate securities as of January 28, 2017, were as follows (in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Auction rate securities	$ 2,700	$ —	$ (282)	$ 2,418
Total available-for-sale investments	$ 2,700	$ —	$ (282)	$ 2,418

The amortized cost, gross unrealized gains, gross unrealized losses, and estimated fair value of the auction rate securities

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as of April 30, 2016, were as follows (in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Auction rate securities	$ 3,100	$ —	$ (320)	$ 2,780
Total available-for-sale investments	$ 3,100	$ —	$ (320)	$ 2,780

The amortized cost and fair value of the auction rate securities by contractual maturity at January 28, 2017, were as follows (in thousands):

	Cost	Fair Value
Due after one through five years	$ 700	$ 677
Due after 10 years	2,000	1,741
Total	$ 2,700	$ 2,418

Equity Securities

At April 30, 2015, the entire balance of available-for-sale equity securities consisted of 618,042 CybAero AB (“CybAero”) common shares. The shares were classified as available-for-sale. These shares were initially acquired on August 11, 2014, when the Company converted a convertible bond into CybAero common shares. The convertible bond was in the amount of 10 million SEK and was converted into 1,062,699 common shares of CybAero at the conversion price of 9.41 SEK per share. When the Company converted the bond on August 11, 2014, the fair value per share was 37.50 SEK which became the new cost basis going forward, with all subsequent changes in fair value being recorded to other comprehensive income.

At August 1, 2015, the Company reviewed these shares for impairment based on criteria that included the extent to which the investment’s carrying value exceeds its related market value, the duration of the market decline, uncertainty as to the recovery period due to sustained losses of the investee and the Company’s intent to hold its investment until recovery. In the three months ended August 1, 2015, the Company determined it was in its best interests to liquidate the remaining shares held. As a result, during the three months ended August 1, 2015, the Company recorded an other than temporary-impairment loss of $2,186,000 related to the Company’s investment in the CybAero shares which was recorded to Other expense in the consolidated statement of operations. As a result of recording the impairment charge, the investment’s fair value became its new cost basis.

In August 2015, the Company sold its remaining shares in CybAero in a private sale at the price of 12.00 SEK per share, resulting in proceeds of approximately $777,000 resulting in realized gains of $207,000, based on the difference between the original conversion price of 9.41 SEK per share and the sales price at the time of sale, inclusive of the final sale of all shares.

3. Fair Value Measurements

Fair value is the price that would be received to sell an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. The fair value hierarchy contains three levels as follows:

· Level 1 — Inputs to the valuation based upon quoted prices (unadjusted) for identical assets or liabilities in active markets that are accessible as of the measurement date.

· Level 2 — Inputs to the valuation include quoted prices in either markets that are not active, or in active markets for similar assets or liabilities, inputs other than quoted prices that are observable, and inputs that are derived principally from or corroborated by observable market data.

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· Level 3 — Inputs to the valuation that are unobservable inputs for the asset or liability.

The Company's financial assets measured at fair value on a recurring basis at January 28, 2017, were as follows (in thousands):

	Fair Value Measurement Using			
Description	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)	Total
Auction rate securities	$ —	$ —	$ 2,418	$ 2,418
Total	$ —	$ —	$ 2,418	$ 2,418

The following table provides a reconciliation between the beginning and ending balances of items measured at fair value on a recurring basis in the table above that used significant unobservable inputs (Level 3) (in thousands):

Description	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)
Balance at May 1, 2016	$ 2,780
Transfers to Level 3	—
Total gains (realized or unrealized)	
Included in earnings	—
Included in other comprehensive income	38
Purchases, issuances and settlements, net	(400)
Balance at January 28, 2017	$ 2,418
The amount of total gains or (losses) for the period included in earnings attributable to the change in unrealized gains or losses relating to assets still held at January 28, 2017	$ —

The auction rate securities are valued using a discounted cash flow model. The analysis considers, among other items, the collateralization underlying the security investments, the creditworthiness of the counterparty, the timing of expected future cash flows and the estimated date upon which the security is expected to have a successful auction. As of January 28, 2017, the inputs used in the Company's discounted cash flow analysis included current coupon rates of 1.31% and 1.19%, estimated redemption periods of 2 and 17 years and discount rates of 5.33% and 14.79%. The discount rates were based on market rates for municipal bond securities, as adjusted for a risk premium to reflect the lack of liquidity of these investments.

4. Inventories, net

Inventories consist of the following (in thousands):

	January 28, 2017	April 30, 2016
Raw materials	$ 17,925	$ 11,609
Work in process	25,061	4,259
Finished goods	30,539	26,073
Inventories, gross	73,525	41,941
Reserve for inventory excess and obsolescence	(4,719)	(4,455)
Inventories, net	$ 68,806	$ 37,486

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5. Warranty Reserves

The Company accrues an estimate of its exposure to warranty claims based upon both current and historical product sales data and warranty costs incurred. The warranty reserve is included in other current liabilities. The related expense is included in cost of sales. Warranty reserve activity is summarized as follows for the three and nine months ended January 28, 2017 and January 30, 2016, respectively (in thousands):

	Three Months Ended		Nine Months Ended	
	January 28, 2017	January 30, 2016	January 28, 2017	January 30, 2016
Beginning balance	$ 3,688	$ 2,338	$ 4,134	$ 2,653
Warranty expense	245	1,032	581	2,740
Changes in estimates related to pre-existing warranties	200	—	1,428	(424)
Warranty costs settled	(679)	(508)	(2,689)	(2,107)
Ending balance	$ 3,454	$ 2,862	$ 3,454	$ 2,862

During the three and nine months ended January 28, 2017, the Company revised its estimates based on the results of additional engineering studies and recorded incremental warranty reserve charges totaling $328,000 and $1,735,000, respectively, related to the estimated costs to repair a component of certain small UAS that were delivered in prior periods. At January 28, 2017, the total remaining warranty reserve related to the estimated costs to repair the impacted UAS was $950,000. As of January 28, 2017 a total of $1,329,000 of costs related to this warranty have been incurred.

6. Accumulated Other Comprehensive Loss and Reclassifications Adjustments

The components of accumulated other comprehensive loss and adjustments are as follows (in thousands):

	Available-for-Sale Securities	Accumulated Other Comprehensive Loss
Balance, net of $134 of taxes, as of April 30, 2016	$ (201)	$ (201)
Reclassifications out of accumulated other comprehensive loss, net of taxes	—	—
Unrealized gains, net of $6 of taxes	32	32

Balance, net of $128 of taxes, as of January 28, 2017	$ (169)	$ (169)

7. Customer-Funded Research & Development

Customer-funded R&D costs are incurred pursuant to contracts (revenue arrangements) to perform R&D activities according to customer specifications. These costs are direct contract costs and are expensed to cost of sales when the corresponding revenue is recognized, which is generally as the R&D services are performed. Revenue from customer-funded R&D was approximately $9,089,000 and $38,367,000 for the three and nine months ended January 28, 2017, respectively. Revenue from customer-funded R&D was approximately $8,877,000 and $35,638,000 for the three and nine months ended January 30, 2016, respectively.

8. Income Taxes

For the three and nine months ended January 28, 2017, the Company recorded a provision (benefit) for income taxes of $1,102,000 and $(2,809,000), respectively, yielding an effective tax rate of (101.9)% and 13.5%, respectively. For the three and nine months ended January 30, 2016, the Company recorded a (benefit) for income taxes of $(1,133,000) and $(2,821,000), respectively, yielding an effective tax benefit rate of (22.5)% and (361.2)%, respectively. The variance from statutory rates for the three and nine months ended January 28, 2017, was primarily due to federal legislation permanently reinstating the federal research and development tax credit retroactive to January 2015 during the third quarter of fiscal 2016 and the reversal of a $968,000 reserve, including the related interest, for uncertain tax positions due to the settlement of prior fiscal year audits recorded during the first quarter of fiscal 2017. The provision for income taxes for the three months ended January 28, 2017 was also impacted by a change in estimate, which decreased the estimated fiscal 2017 effective income tax rate. The variance from statutory rates for the three and nine months ended

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January 30, 2016, was primarily due to federal legislation permanently reinstating the federal research and development tax credit retroactive to January 2015 during the third quarter of fiscal 2016.

9. Share Repurchase

In September 2015, the Company's Board of Directors authorized a program to repurchase up to $25,000,000 of the Company's common stock with no specified termination date for the program. No shares were repurchased under the program during the nine months ended January 28, 2017. As of January 28, 2017 and April 30, 2016, approximately $21.2 million remained authorized for future repurchases under this program.

10. Segment Data

The Company's product segments are as follows:

· Unmanned Aircraft Systems — The UAS segment focuses primarily on the design, development, production, support and operation of innovative UAS and tactical missile systems that provide situational awareness, multi-band communications, force protection and other mission effects to increase the security and effectiveness of the operations of the Company's customers.

· Efficient Energy Systems — The EES segment focuses primarily on the design, development, production, marketing, support and operation of innovative efficient electric energy systems that address the growing demand for electric transportation solutions.

The accounting policies of the segments are the same as those described in Note 1, "Organization and Significant Accounting Policies." The operating segments do not make sales to each other. Depreciation and amortization related to the manufacturing of goods is included in gross margin for the segments. The Company does not discretely allocate assets to its operating segments, nor does the CODM evaluate operating segments using discrete asset information. Consequently, the Company operates its financial systems as a single segment for accounting and control purposes, maintains a single indirect rate structure across all segments, has no inter-segment sales or corporate elimination transactions, and maintains limited financial statement information by segment. The segment results are as follows (in thousands):

	Three Months Ended		Nine Months Ended	
	January 28,	January 30,	January 28,	January 30,

	2017	2016	2017	2016
Revenue:				
UAS	$ 41,894	$ 61,086	$ 113,220	$ 157,842
EES	11,269	6,474	26,277	21,499
Total	53,163	67,560	139,497	179,341
Cost of sales:				
UAS	25,530	36,488	76,549	91,268
EES	8,282	4,447	19,497	13,892
Total	33,812	40,935	96,046	105,160
Gross margin:				
UAS	16,364	24,598	36,671	66,574
EES	2,987	2,027	6,780	7,607
Total	19,351	26,625	43,451	74,181
Selling, general and administrative	12,788	13,313	39,838	43,302
Research and development	7,988	8,247	25,105	27,975
(Loss) income from operations	(1,425)	5,065	(21,492)	2,904
Other income (expense):				
Interest income, net	390	181	1,162	673
Other expense, net	(46)	(215)	(476)	(2,796)
(Loss) income before income taxes	$ (1,081)	$ 5,031	$ (20,806)	$ 781

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11. Subsequent Events

On February 1, 2017, the Company acquired an additional 36% interest in our Turkish joint venture, Altoy Savunma Sanayi ve Havacilik Anonim Sirketi (“Altoy”), increasing the Company’s total ownership interest to 85%, for total cash consideration of $625,000. As a result of the Company obtaining a controlling interest in Altoy, Altoy will be consolidated into the consolidated financial statements of the Company. At January 28, 2017 and April 30, 2016, the financial results of Altoy were recorded in the Company’s consolidated financial statements as an equity method investment.

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

The following is a discussion and analysis of our financial condition and the results of operations as of and for the periods presented below. The following discussion and analysis should be read in conjunction with the "Consolidated Financial Statements" and notes thereto included elsewhere in this Quarterly Report on Form 10-Q. This section and other parts of this Quarterly Report on Form 10-Q contain forward-looking statements that involve risks and uncertainties. In some cases, forward-looking statements can be identified by words such as "anticipates," "believes," "could," "estimates," "expects," "intends," "may," "plans," "potential," "predicts," "projects," "should," "will," "would" or sin Such forward-looking statements are based on current expectations, estimates and projections about our industry, our management's beliefs and assumptions made by our management. Forward-looking statements are not guarantees of future performance and our actual results may differ significantly from the results discussed in the forward-looking statements. Factors that might cause such differences include, but are not limited to, those discussed in Part I, Item 1A, "Risk Factors" in our Annual Report on Form 10-K for the fiscal year ended April 30, 2016, as updated by our subsequent filings under the Securities and Exchange Act of 1934, as amended, ("the Exchange Act").

Unless required by law, we expressly disclaim any obligation to update publicly any forward-looking statements, whether as result of new information, future events or otherwise.

Critical Accounting Policies and Estimates

Management's Discussion and Analysis of Financial Condition and Results of Operations discusses our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. When we prepare these consolidated financial statements, we are required to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Some of our accounting policies require that we make subjective judgments, including estimates that involve matters that are inherently uncertain. Our most critical estimates include those related to revenue recognition, inventories and reserves for excess and obsolescence, warranty liabilities, self-insured liabilities, accounting for stock-based awards, and income taxes. We base our estimates and judgments on historical experience and on various other factors that we believe to be reasonable under the circumstances, the results of which form the basis for our judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Our actual results may differ from these estimates under different assumptions or conditions.

There have been no material changes made to the critical accounting estimates during the periods presented in the consolidated financial statements from those disclosed in our Annual Report on Form 10-K for the fiscal year ended April 30, 2016.

We review cost performance and estimates-to-complete at least quarterly and in many cases more frequently. Adjustments to original estimates for a contract's revenue, estimated costs at completion and estimated profit or loss are often required as work progresses under a contract, as experience is gained and as more information is obtained, even though the scope of work required under the contract may not change, or if contract modifications occur. The impact of revisions in profit estimates for all types of contracts are recognized on a cumulative catch-up basis in the period in which the revisions are made. During the three and nine months ended January 28, 2017 and January 30, 2016, changes in accounting estimates on fixed-price contracts recognized using the percentage of completion method of accounting are presented below.

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For the three months ended January 28, 2017 and January 30, 2016, favorable and unfavorable cumulative catch-up adjustments included in cost of sales were as follows (in thousands):

	Three Months Ended	
	January 28, 2017	January 30, 2016
Gross favorable adjustments	$ 258	$ 458
Gross unfavorable adjustments	(227)	(203)
Net favorable adjustments	$ 31	$ 255

For the three months ended January 28, 2017, favorable cumulative catch-up adjustments of $0.3 million were primarily due to final cost adjustments on 14 contracts, which individually were not material. For the same period, unfavorable cumulative catch-up adjustments of $0.2 million were primarily related to higher than expected costs on six contracts, which individually were not material.

For the three months ended January 30, 2016, favorable cumulative catch-up adjustments of $0.5 million were primarily due to final cost adjustments on 14 contracts, which individually were not material. For the same period, unfavorable cumulative catch-up adjustments of $0.2 million were primarily related to higher than expected costs on 15 contracts, which individually were not material.

For the nine months ended January 28, 2017 and January 30, 2016, favorable and unfavorable cumulative catch-up adjustments included in cost of sales were as follows (in thousands):

	Nine Months Ended	
	January 28, 2017	January 30, 2016
Gross favorable adjustments	$ 2,352	$ 473
Gross unfavorable adjustments	(271)	(245)
Net favorable adjustments	$ 2,081	$ 228

For the nine months ended January 28, 2017, favorable cumulative catch-up adjustments of $2.4 million were primarily due to final cost adjustments on 50 contracts, which individually were not material. For the same period, unfavorable cumulative catch-up adjustments of $0.3 million were primarily related to higher than expected costs on 11 contracts, which individually were not material.

For the nine months ended January 30, 2016, favorable cumulative catch-up adjustments of $0.5 million were primarily due to final cost adjustments on 16 contracts, which individually were not material. For the same period, unfavorable cumulative catch-up adjustments of $0.2 million were primarily related to higher than expected costs on 15 contracts, which individually were not material.

Fiscal Periods

Due to our fixed year end date of April 30, our first and fourth quarters each consist of approximately 13 weeks. The second and third quarters each consist of exactly 13 weeks. Our first three quarters end on a Saturday. Our 2017 fiscal year ends on April 30, 2017 and our fiscal quarters end on July 30, 2016, October 29, 2016 and January 28, 2017, respectively.

Results of Operations

Our operating segments are Unmanned Aircraft Systems, or UAS, and Efficient Energy Systems, or EES. Our accounting policies for each of these segments are the same. In addition, a significant portion of our research and development, or R&D, selling, general and administrative, or SG&A, and general overhead resources are shared across our segments.

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The following table sets forth our revenue and gross margin generated by each operating segment for the periods indicated (in thousands):

Three Months Ended January 28, 2017 Compared to Three Months Ended January 30, 2016

	Three Months Ended January 28, 2017	Three Months Ended January 30, 2016
Revenue:		
UAS	$ 41,894	$ 61,086
EES	11,269	6,474
Total	53,163	67,560
Cost of sales:		
UAS	25,530	36,488
EES	8,282	4,447
Total	33,812	40,935
Gross margin:		
UAS	16,364	24,598
EES	2,987	2,027
Total	19,351	26,625
Selling, general and administrative	12,788	13,313
Research and development	7,988	8,247
(Loss) income from operations	(1,425)	5,065
Other income (expense):		
Interest income, net	390	181
Other expense, net	(46)	(215)
(Loss) income before income taxes	$ (1,081)	$ 5,031

Revenue. Revenue for the three months ended January 28, 2017 was $53.2 million, as compared to $67.6 million for the three months ended January 30, 2016, representing a decrease of $14.4 million, or 21%. The decrease in revenue was due to a decrease in product deliveries of $16.6 million, partially offset by an increase in service revenue of $2.2 million. UAS revenue decreased $19.2 million, or 31%, to $41.9 million for the three months ended January 28, 2017, due to a decrease in product deliveries of $21.5 million, partially offset by an increase in service revenue of $2.1 million and an increase in customer-funded R&D work of $0.2 million. The decrease in product deliveries was primarily due to a decrease in product deliveries of small UAS, partially offset by an increase in product deliveries of tactical missile systems. The decrease in UAS product deliveries was also a result of year over year timing differences in shipments, primarily driven by the timing of contract funding by our customers. The increase in service revenue was primarily due to an increase in services associated with tactical missile systems and an increase in sustainment activities in support of small UAS. EES revenue increased $4.8 million, or 74%, to $11.3 million for the three months ended January 28, 2017, primarily due to an increase in product deliveries of power cycling and test systems and industrial electric vehicle charging systems.

Cost of Sales. Cost of sales for the three months ended January 28, 2017 was $33.8 million, as compared to $40.9 million for the three months ended January 30, 2016, representing a decrease of $7.1 million, or 17%. As a percentage of revenue, cost of sales increased from 61% to 64%. The decrease in cost of sales was primarily due to a decrease in product costs of $8.3 million, partially offset by an increase in cost of services of $1.1 million. The decrease in product costs was primarily due to the decrease in product deliveries, partially offset by an increase in engineering and technical analyses costs ("sustaining engineering activities") in support of our existing products. The increase in cost of services was primarily due to the increase in service revenue. UAS cost of sales decreased $11.0 million, or 30%, to $25.5 million for the three months ended January 28, 2017, primarily due to a decrease in product deliveries, partially offset by an increase in sustaining engineering activities in support of our existing products. As a percentage of revenue, cost of sales for UAS increased from 60% to 61%, primarily due to the increase in sustaining engineering activities in support of our existing products. EES cost of sales increased $3.8 million, or 86%, to $8.3 million for the three months

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ended January 28, 2017, primarily due to the increased sales volume and the increase in sustaining engineering activities in support of our existing products. As a percentage of revenue, cost of sales for EES increased from 69% to 73% primarily due to the increase in sustaining engineering activities in support of our existing products.

Gross Margin. Gross margin for the three months ended January 28, 2017 was $19.4 million, as compared to $26.6 million for the three months ended January 30, 2016, representing a decrease of $7.3 million, or 27%. The decrease in gross margin was primarily due to a decrease in product margins of $8.3 million, partially offset by an increase in service margins of $1.0 million. As a percentage of revenue, gross margin decreased from 39% to 36%, primarily due to an increase in sustaining engineering activities in support of our existing products. UAS gross margin decreased to $16.4 million for the three months ended January 28, 2017 from $24.6 million. As a percentage of revenue, gross margin for UAS decreased from 40% to 39%, primarily due to the increase in sustaining engineering activities in support of our existing products. EES gross margin increased $1.0 million, or 47%, to $3.0 million for the three months ended January 28, 2017, primarily due to the increased sales volume, partially offset by the increase in sustaining engineering activities in support of our existing products. As a percentage of revenue, EES gross margin decreased from 31% to 27%, primarily due to the increase in sustaining engineering activities in support of our existing products.

Selling, General and Administrative. SG&A expense for the three months ended January 28, 2017 was $12.8 million, or 24% of revenue, compared to SG&A expense of $13.3 million, or 20% of revenue, for the three months ended January 30, 2016. SG&A expense decreased by $0.5 million, or 4%, for the three months ended January 28, 2017 primarily due to a decrease in bonus expense.

Research and Development. R&D expense for the three months ended January 28, 2017 was $8.0 million, or 15% of revenue, compared to R&D expense of $8.2 million, or 12% of revenue, for the three months ended January 30, 2016. R&D expense decreased by $0.3 million, or 3%, for the three months ended January 28, 2017.

Interest Income, net. Interest income, net for the three months ended January 28, 2017 was $0.4 million compared to interest income, net of $0.2 million for the three months ended January 30, 2016.

Other Expense, net. Other expense, net for the three months ended January 28, 2017 was $46,000 compared to other expense, net of $0.2 million for the three months ended January 30, 2016.

(Benefit) Provision for Income Taxes. Our effective income tax rate was 101.9% for the three months ended January 28, 2017, as compared to (22.5)% for the three months ended January 30, 2016. The effective income tax rate for the three months ended January 28, 2017 was impacted by a change in estimate which decreased our estimated fiscal 2017 effective income tax rate, federal legislation permanently reinstating the federal research and development tax credit retroactive to January 2015 during the three months ended January 30, 2016 and the reversal of a reserve for uncertain tax positions due to the settlement of prior fiscal year audits.

Nine Months Ended January 28, 2017 Compared to Nine Months Ended January 30, 2016

	Nine Months Ended	
	January 28, 2017	January 30, 2016
Revenue:		
UAS	$ 113,220	$ 157,842
EES	26,277	21,499
Total	139,497	179,341
Cost of sales:		
UAS	76,549	91,268
EES	19,497	13,892
Total	96,046	105,160
Gross margin:		
UAS	36,671	66,574
EES	6,780	7,607

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Total	43,451	74,181
Selling, general and administrative	39,838	43,302
Research and development	25,105	27,975
(Loss) income from operations	(21,492)	2,904
Other income (expense):		
Interest income, net	1,162	673
Other (expense), net	(476)	(2,796)
(Loss) income before income taxes	$ (20,806)	$ 781

Revenue. Revenue for the nine months ended January 28, 2017 was $139.5 million, as compared to $179.3 million for the nine months ended January 30, 2016, representing a decrease of $39.8 million, or 22%. The decrease in revenue was due to a decrease in product deliveries of $47.6 million, partially offset by an increase in service revenue of $7.8 million. UAS revenue decreased $44.6 million, or 28%, to $113.2 million for the nine months ended January 28, 2017, primarily due to a decrease in product deliveries of $52.8 million, partially offset by an increase in service revenue of $5.4 million and an increase in customer-funded R&D work of $2.7 million. The decrease in product deliveries was primarily due to a decrease in product deliveries of small UAS, partially offset by an increase in product deliveries of tactical missile systems. The decrease in UAS product deliveries was also a result of year over year timing differences in shipments, primarily driven by the timing of contract funding by our customers. The increase in service revenue was primarily due to an increase in services associated with tactical missile systems and an increase in sustainment activities in support of small UAS. The increase in customer-funded R&D was primarily associated with tactical missile system variant programs. EES revenue increased $4.8 million, or 22%, to $26.3 million for the nine months ended January 28, 2017, primarily due to an increase in product deliveries of power cycling and test systems, passenger and fleet electric vehicle charging systems and industrial electric vehicle charging systems.

Cost of Sales. Cost of sales for the nine months ended January 28, 2017 was $96.0 million, as compared to $105.2 million for the nine months ended January 30, 2016, representing a decrease of $9.1 million, or 9%. As a percentage of revenue, cost of sales increased from 59% to 69%. The decrease in cost of sales was primarily due to a decrease in product costs of $15.4 million, partially offset by an increase in service costs of $6.3 million, both of which were impacted by the reserve reversal of $3.5 million for the settlement of prior year government incurred cost audits recorded in the second quarter of fiscal 2016. The decrease in product costs was primarily due to the decrease in product deliveries, partially offset by the prior year reserve reversal for the settlement of prior year government incurred cost audits, an increase in sustaining engineering activities in support of our existing products and an increase in warranty related costs of $2.0 million related to certain small UAS delivered in prior periods. The increase in cost of services was primarily due to the increase in service revenue. UAS cost of sales decreased $14.7 million, or 16%, to $76.5 million for the nine months ended January 28, 2017, primarily due to the decrease in product deliveries, partially offset by the prior year reserve reversal of $3.1 million for the settlement of prior year government incurred cost audits, an increase in sustaining engineering activities in support of our existing products and an increase in warranty related costs of $2.0 million related to certain small UAS delivered in prior periods. As a percentage of revenue, cost of sales for UAS increased from 58% to 68%, primarily due to the prior year reserve reversal for the settlement of prior year government incurred cost audits, an increase in sustaining engineering activities in support of our existing products combined with the decreased sales volume and the increase in small UAS warranty related costs. EES cost of sales increased $5.6 million, or 40%, to $19.5 million for the nine months ended January 28, 2017, primarily due to the increase in product deliveries, the increase in sustaining engineering activities in support of our existing products and the prior year reserve reversal of $0.4 million for the settlement of prior year government incurred cost audits. As a percentage of revenue, cost of sales for EES increased from 65% to 74% primarily due to the increase in sustaining engineering activities in support of our existing products and the prior year reserve reversal for the settlement of prior year government incurred cost audits.

Gross Margin. Gross margin for the nine months ended January 28, 2017 was $43.5 million, as compared to $74.2 million for the nine months ended January 30, 2016, representing a decrease of $30.7 million, or 41%. The decrease in gross margin was primarily due to a decrease in product margins of $32.2 million, partially offset by an increase in service margins of $1.5 million, both of which were impacted by the reserve reversal of $3.5 million for the settlement of prior year government incurred cost audits recorded in the second quarter of fiscal 2016. As a percentage of revenue, gross margin decreased from 41% to 31%, primarily due to the prior year reserve reversal for the settlement of

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prior year government incurred cost audits, an increase in sustaining engineering activities in support of our existing products and an increase in warranty related costs of $2.0 million related to certain small UAS delivered in prior periods. UAS gross margin decreased to $36.7 million for the nine months ended January 28, 2017 from $66.6 million. As a percentage of revenue, gross margin for UAS decreased from 42% to 32%, primarily due to the prior year reserve reversal of $3.1 million for the settlement of prior year government incurred cost audits, an increase in sustaining engineering activities in support of our existing products combined with the decreased sales volume and the increase in small UAS warranty related costs. EES gross margin decreased $0.8 million, or 11%, to $6.8 million for the nine months ended January 28, 2017 primarily due to an increase in sustaining engineering activities in support of our existing products and the prior year reserve reversal of $0.4 million for the settlement of prior year government incurred cost audits, partially offset by the increased sales volume. As a percentage of revenue, EES gross margin decreased from 35% to 26% primarily due to the increase in sustaining engineering activities in support of our existing products and the prior year reserve reversal for the settlement of prior year government incurred cost audits.

Selling, General and Administrative. SG&A expense for the nine months ended January 28, 2017 was $39.8 million, or 29% of revenue, compared to SG&A expense of $43.3 million, or 24% of revenue, for the nine months ended January 30, 2016. SG&A expense decreased by $3.5 million, or 8%, for the nine months ended January 28, 2017 primarily due to a decrease in bid and proposal costs, a decrease in professional services and a decrease in bonus expense.

Research and Development. R&D expense for the nine months ended January 28, 2017 was $25.1 million, or 18% of revenue, compared to R&D expense of $28.0 million, or 16% of revenue, for the nine months ended January 30, 2016. R&D expense decreased by $2.9 million, or 10%, for the nine months ended January 28, 2017 primarily due to a decrease in development activities for certain strategic initiatives.

Interest Income, net. Interest income, net for the nine months ended January 28, 2017 was $1.2 million compared to interest income, net of $0.7 million for the nine months ended January 30, 2016.

Other Expense, net. Other expense, net for the nine months ended January 28, 2017 was $0.5 million compared to other expense, net of $2.8 million for the nine months ended January 30, 2016. The decrease was primarily due to the recording of an other-than-temporary impairment loss of $2.2 million on our CybAero equity securities during the nine months ended January 30, 2016. The CybAero equity securities were sold during the second quarter of fiscal 2016.

Benefit for Income Taxes. Our effective income tax benefit rate was 13.5% for the nine months ended January 28, 2017, as compared to an effective income tax benefit rate of 361.2% for the nine months ended January 30, 2016. The variance from statutory rates for the nine months ended January 28, 2017, was primarily due to federal legislation permanently reinstating the federal research and development tax credit retroactive to January 2015 during the three months ended January 30, 2016 and the reversal of a reserve for uncertain tax positions due to the settlement of prior fiscal year audits.

Backlog

We define funded backlog as unfilled firm orders for products and services for which funding currently is appropriated to us under the contract by the customer. As of January 28, 2017 and April 30, 2016, our funded backlog was approximately $128.2 million and $65.8 million, respectively.

In addition to our funded backlog, we also had unfunded backlog of $24.2 million and $16.7 million as of January 28, 2017 and April 30, 2016, respectively. We define unfunded backlog as the total remaining potential order amounts under cost reimbursable and fixed price contracts with multiple one-year options, and indefinite delivery, indefinite quantity, or IDIQ contracts. Unfunded backlog does not obligate the U.S. government to purchase goods or services. There can be no assurance that unfunded backlog will result in any orders in any particular period, if at all. Management believes that unfunded backlog does not provide a reliable measure of future estimated revenue under our contracts. Unfunded backlog does not include the remaining potential value associated with a U.S. Army IDIQ-type contract for small UAS because the contract was awarded to five companies in 2012, including AeroVironment, and we cannot be certain that we will receive task orders issued against the contract.

Because of possible future changes in delivery schedules and/or cancellations of orders, backlog at any particular date is not necessarily representative of actual sales to be expected for any succeeding period, and actual sales for the year may not meet or exceed the backlog represented. Our backlog is typically subject to large variations from quarter to quarter as existing contracts expire, or are renewed, or new contracts are awarded. A majority of our contracts, specifically our IDIQ contracts, do not currently obligate the U.S. government to purchase any goods or services. Additionally, all U.S. government contracts included in backlog, whether or not they are funded, may be terminated at the convenience of the U.S. government.

Liquidity and Capital Resources

We currently have no material cash commitments, except for normal recurring trade payables, accrued expenses and ongoing R&D costs, all of which we anticipate funding through our existing working capital and funds provided by operating activities. The majority of our purchase obligations are pursuant to funded contractual arrangements with our customers. In addition, we believe that our existing cash, cash equivalents, cash provided by operating activities and other financing sources will be sufficient to meet our anticipated working capital and capital expenditure requirements during the next twelve months. There can be no assurance, however, that our business will continue to generate cash flow at current levels. If we are unable to generate sufficient cash flow from operations, then we may be required to sell assets, reduce capital expenditures or obtain financing. We anticipate that existing sources of liquidity and cash flows from operations will be sufficient to satisfy our cash needs for the foreseeable future.

Our primary liquidity needs are for financing working capital, investing in capital expenditures, supporting product development efforts, introducing new products, enhancing existing products and marketing to stimulate acceptance and adoption of our products and services. Our future capital requirements, to a certain extent, are also subject to general conditions in or affecting the defense, commercial and electric vehicle industries and are subject to general economic, political, financial, competitive, legislative and regulatory factors that are beyond our control. To the extent that existing cash, cash equivalents, and cash from operations are insufficient to fund our future activities, we may need to raise additional funds through public or private equity or debt financing. We may also need to seek additional equity funding or debt financing if we become a party to any agreement or letter of intent for potential investments in, or acquisitions of, businesses, services or technologies.

Our working capital requirements vary by contract type. On cost-plus-fee programs, we typically bill our incurred costs and fees monthly as work progresses, and therefore working capital investment is minimal. On fixed-price contracts, we typically are paid as we deliver products, and working capital is needed to fund labor and other expenses incurred during the lead time from contract award until contract deliveries begin.

Cash Flows

The following table provides our cash flow data for the nine months ended January 28, 2017 and January 30, 2016 (in thousands):

	Nine Months Ended	
	January 28, 2017	January 30, 2016
	(Unaudited)	
Net cash used in operating activities	$ (14,424)	$ (5,699)
Net cash used in investing activities	$ (36,949)	$ (11,905)
Net cash provided by (used in) financing activities	$ 364	$ (3,100)

Cash Used in Operating Activities. Net cash used in operating activities for the nine months ended January 28, 2017 increased by $8.7 million to $14.4 million, compared to net cash used in operating activities of $5.7 million for the nine months ended January 30, 2016. The increase in net cash used in operating activities was primarily due to an increase in net loss of $21.6 million and a decrease in non-cash charges primarily due to the other than temporary impairment charge on the CybAero available-for-sale equity securities of $2.2 million during the nine months ended January 30, 2016, partially offset by a decrease in the use of cash as a result of changes in operating assets and liabilities of $16.8 million,

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largely resulting from decreases in accounts receivable due to the year over year timing of revenue, partially offset by increases in inventory to support expected product deliveries.

Cash Used in Investing Activities. Net cash used in investing activities increased by $25.0 million to $36.9 million for the nine months ended January 28, 2017, compared to net cash used in investing activities of $11.9 million for the nine months ended January 30, 2016. The increase in net cash used in investing activities was primarily due to a decrease in net redemptions and purchases of investments of $22.0 million and an increase in cash paid for acquisitions of property and equipment of $3.3 million.

Cash Provided by (Used in) Financing Activities. Net cash provided by financing activities increased by $3.5 million to $0.4 million for the nine months ended January 28, 2017, compared to net cash used in financing activities of $3.1 million for the nine months ended January 30, 2016. The increase in cash provided by financing activities was primarily due a decrease in the purchase and retirement of common stock of $3.8 million.

Contractual Obligations

During the nine months ended January 28, 2017, there were no material changes in our contractual obligations and commercial commitments from those disclosed in our Annual Report on Form 10-K for the fiscal year ended April 30, 2016.

Off-Balance Sheet Arrangements

As of January 28, 2017, we had no off balance sheet arrangements as defined in Item 303(a)(4) of the SEC’s Regulation S K.

Inflation

Our operations have not been, and we do not expect them to be, materially affected by inflation. Historically, we have been successful in adjusting prices to our customers to reflect changes in our material and labor costs.

New Accounting Standards

Please refer to Note 1 “Organization and Significant Accounting Policies” to our unaudited consolidated financial statements in Part I, Item 1 of this Quarterly Report on Form 10-Q for a discussion of new accounting pronouncements and accounting pronouncements adopted during the nine months ended January 28, 2017.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

In the ordinary course of business, we are exposed to various market risk factors, including fluctuations in interest rates, changes in general economic conditions, domestic and foreign competition, and foreign currency exchange rates.

Interest Rate Risk

It is our policy not to enter into interest rate derivative financial instruments. We do not currently have any significant interest rate exposure.

Foreign Currency Exchange Rate Risk

Since a significant part of our sales and expenses are denominated in U.S. dollars, we have not experienced significant foreign exchange gains or losses to date, and do not expect to incur significant foreign exchange gains or losses in the future.

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ITEM 4. CONTROLS AND PROCEDURES

Controls and Procedures

We maintain disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) that are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow for timely decisions regarding required disclosure.

In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

As required by Rule 13a-15(b) under the Exchange Act, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures, as of January 28, 2017, the end of the period covered by this Quarterly Report on Form 10-Q.

Based on the foregoing, our Chief Executive Officer and Chief Financial Officer concluded that, as of January 28, 2017, the end of the period covered by this Quarterly Report on Form 10-Q, our disclosure controls and procedures were effective and were operating at a reasonable assurance level.

Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting or in other factors identified in connection with the evaluation required by paragraph (d) of Rules 13a-15 or 15d-15 under the Exchange Act that occurred during the quarter ended January 28, 2017 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act).

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PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

We are not currently a party to any material legal proceedings. We are, however, subject to lawsuits, government investigations, audits and other legal proceedings from time to time in the ordinary course of our business. It is not possible to predict the outcome of any legal proceeding with certainty. The outcome or costs we incur in connection with a legal proceeding could adversely impact our operating results and financial position.

ITEM 1A. RISK FACTORS

There have been no material changes to the risk factors disclosed under Part I, Item 1A, "Risk Factors," of our Annual Report on Form 10-K for the fiscal year ended April 30, 2016. Please refer to that section for disclosures regarding the risks and uncertainties related to our business.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Issuer Purchases of Equity Securities

On September 24, 2015, we announced that on September 23, 2015 our Board of Directors authorized a share repurchase program (the "Share Repurchase Program"), pursuant to which we may repurchase up to $25 million of our common stock from time to time, in amounts and at prices we deem appropriate, subject to market conditions and other considerations. Share repurchases may be executed through open market transactions or negotiated purchases and may be made under a Rule 10b5-1 plan. There is no expiration date for the program. The Share Repurchase Program does not obligate us to acquire any particular amount of common stock and may be suspended at any time by our Board of Directors. No shares were repurchased in the nine months ended January 28, 2017. As of January 28, 2017, approximately $21.2 million remained authorized for future repurchases under this program.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

Exhibit Number	Description
3.1(1)	Amended and Restated Certificate of Incorporation of AeroVironment, Inc.
3.2(2)	Third Amended and Restated Bylaws of AeroVironment, Inc.
31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended.
31.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended.
32#	Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.INS	XBRL Instance Document.

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101.SCH	XBRL Taxonomy Extension Schema Document.
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document.
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document.
101.LAB	XBRL Taxonomy Extension Label Linkbase Document.
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document.

(1) Incorporated by reference herein to Exhibit 3.1 to the Company's Quarterly Report on Form 10 Q filed March 9, 2007 (File No. 001 33261).

(2) Incorporated by reference herein to Exhibit 3.3 to the Company's Annual Report on Form 10-K filed July 1, 2015 (File No. 001-33261).

#The information in Exhibit 32 shall not be deemed "filed" for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, or the Exchange Act, or otherwise subject to the liabilities of that section, nor shall it be deemed incorporated by reference in any filing under the Securities Act of 1933, as amended, or the Exchange Act (including this report), unless the Company specifically incorporates the foregoing information into those documents by reference.

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SIGNATURES

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

Date: March 7, 2017		AEROVIRONMENT, INC.
	By:	/s/ Wahid Nawabi Wahid Nawabi President and Chief Executive Officer (Principal Executive Officer)
		/s/ Teresa P. Covington Teresa P. Covington Senior Vice President and Chief Financial Officer (Principal Financial and Accounting Officer)