

CYANOTECH CORP  
Form 10-Q  
November 14, 2011  
[Table of Contents](#)

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

**x Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

**For Quarterly Period Ended September 30, 2011**

**Or**

**o Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

**For the Transition Period From                      to**

**Commission File Number 0-14602**

**CYANOTECH CORPORATION**

(Exact name of registrant as specified in its charter)

Edgar Filing: CYANOTECH CORP - Form 10-Q

NEVADA  
(State or other jurisdiction  
of incorporation or organization)

91-1206026  
(IRS Employer  
Identification Number)

73-4460 Queen Kaahumanu Hwy. #102, Kailua-Kona, HI 96740

(Address of principal executive offices)

(808) 326-1353

(Registrant's telephone number)

Not Applicable

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

Indicate by check mark whether the registrant (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act of 1934 during the past 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 definitions of large accelerated filer, accelerated filer, and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer   
Non-accelerated filer  Smaller reporting company   
(Do not check if a 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

Number of common shares outstanding as of November 14, 2011:

Title of Class	Shares Outstanding
Common stock - \$0.02 par value	5,405,618



Table of Contents

CYANOTECH CORPORATION

FORM 10-Q

INDEX

**PART I. FINANCIAL INFORMATION**

<u>Item 1.</u>	<u>Financial Statements (unaudited)</u>	3
	<u>Condensed Consolidated Balance Sheets as of September 30, 2011 and March 31, 2011</u>	3
	<u>Condensed Consolidated Statements of Operations for the three and six month periods ended September 30, 2011 and 2010</u>	4
	<u>Condensed Consolidated Statements of Cash Flows for the six month periods ended September 30, 2011 and 2010</u>	5
	<u>Notes to Consolidated Condensed Financial Statements</u>	6
<u>Item 2.</u>	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	13
<u>Item 3.</u>	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	18
<u>Item 4.</u>	<u>Controls and Procedures</u>	18

**PART II. OTHER INFORMATION**

<u>Item 1.</u>	<u>Legal Proceedings</u>	19
<u>Item 2.</u>	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	19
<u>Item 3.</u>	<u>Defaults upon Senior Securities</u>	19
<u>Item 5.</u>	<u>Other Information</u>	19
<u>Item 6.</u>	<u>Exhibits</u>	20
<u>SIGNATURES</u>		21

Table of Contents**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements** (Unaudited)

## CYANOTECH CORPORATION

## CONDENSED CONSOLIDATED BALANCE SHEETS

(Dollars in thousands except par value and number of shares)

(Unaudited)

	September 30, 2011	March 31, 2011
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 4,091	\$ 2,062
Accounts receivable, net of allowance for doubtful accounts of \$58 at September 30, 2011 and March 31, 2011	2,524	2,641
Inventories, net	3,188	3,627
Deferred tax assets	17	17
Prepaid expenses and other assets	225	134
Total current assets	10,045	8,481
Equipment and leasehold improvements, net	4,871	4,557
Deferred tax assets	535	535
Other assets	275	287
Total assets	\$ 15,726	\$ 13,860
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Current maturities of long-term debt	\$ 224	\$ 204
Customer deposits	77	115
Accounts payable	1,236	1,054
Accrued expenses	1,019	823
Total current liabilities	2,556	2,196
Long-term debt, excluding current maturities	493	553
Total liabilities	3,049	2,749
Commitments and contingencies		
Stockholders' equity:		
Common stock of \$0.02 par value, shares authorized 7,500,000; 5,405,618 shares issued and outstanding at September 30, 2011 and 5,391,968 shares at March 31, 2011	108	108
Additional paid-in capital	28,008	27,803
Accumulated deficit	(15,439)	(16,800)
Total stockholders' equity	12,677	11,111

Edgar Filing: CYANOTECH CORP - Form 10-Q

Total liabilities and stockholders' equity	\$	15,726	\$	13,860
--	----	--------	----	--------

See accompanying Notes to Condensed Consolidated Financial Statements.

Table of Contents

## CYANOTECH CORPORATION

## CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Dollars in thousands, except per share amounts)

(Unaudited)

	Three Months Ended September 30,		Six Months Ended September 30,	
	2011	2010	2011	2010
NET SALES	\$ 5,989	\$ 3,834	\$ 11,939	\$ 7,690
COST OF SALES	3,199	2,182	7,045	4,379
Gross profit	2,790	1,652	4,894	3,311
<b>OPERATING EXPENSES:</b>				
General and administrative	1,117	643	2,065	1,406
Sales and marketing	609	393	1,176	776
Research and development	89	62	160	146
Loss on disposal of equipment and leasehold improvements	62		64	
Total operating expenses	1,877	1,098	3,465	2,328
Income from operations	913	554	1,429	983
Interest expense, net	(10)	(18)	(24)	(38)
Income before provision for income taxes	903	536	1,405	945
PROVISION FOR INCOME TAXES	28	10	44	20
NET INCOME	\$ 875	\$ 526	\$ 1,361	\$ 925
<b>NET INCOME PER SHARE:</b>				
Basic	\$ .16	\$ .10	\$ .25	\$ .17
Diluted	\$ .16	\$ .10	\$ .25	\$ .17
<b>SHARES USED IN CALCULATION OF NET INCOME PER SHARE:</b>				
Basic	5,398	5,374	5,397	5,314
Diluted	5,473	5,390	5,471	5,333

See accompanying Notes to Condensed Consolidated Financial Statements.

Table of Contents

## CYANOTECH CORPORATION

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in thousands)

(Unaudited)

	2011	Six Months Ended September 30,	2010
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net income	\$	1,361	\$ 925
Adjustments to reconcile net income to net cash provided by operating activities:			
Loss on disposal of equipment and leasehold improvements		64	
Depreciation and amortization		337	279
Amortization of debt issue costs and other assets		21	14
Share based compensation expense		200	36
Net (increase) decrease in assets:			
Accounts receivable		117	(66)
Inventories		439	(680)
Prepaid expenses and other assets		(100)	(30)
Net increase (decrease) in liabilities:			
Customer deposits		(38)	10
Accounts payable		182	(436)
Accrued expenses		196	(38)
Net cash provided by operating activities		2,779	14
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Investment in equipment and leasehold improvements		(716)	(307)
Proceeds from return of restricted cash			250
Net cash used in investing activities		(716)	(57)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Proceeds from long term debt, net of costs		65	
Principal payments on long-term debt		(105)	(176)
Proceeds from stock options exercised		6	185
Net cash provided by (used in) financing activities		(34)	9
Net increase (decrease) in cash and cash equivalents			
		2,029	(34)
Cash and cash equivalents at beginning of period			
		2,062	817
Cash and cash equivalents at end of period			
	\$	4,091	\$ 783
<b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:</b>			
Cash paid during the period for:			
Interest	\$	21	\$ 25
Income taxes	\$	18	\$ 12

See accompanying Notes to Condensed Consolidated Financial Statements.



Table of Contents

CYANOTECH CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

As of September 30, 2011

(Unaudited)

**1. BASIS OF PRESENTATION**

The accompanying condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ( GAAP ) for interim financial information pursuant to the instructions to Form 10-Q and Regulation S-X. These interim condensed consolidated financial statements are unaudited and, in the opinion of management, include all adjustments (consisting of normal recurring adjustments and accruals) necessary to present fairly the Condensed Consolidated Balance Sheets, Condensed Consolidated Statements of Operations, and Condensed Consolidated Statements of Cash Flows for the periods presented in accordance with GAAP. Accordingly, they do not include all of the information and notes required by GAAP for complete financial statements. The condensed consolidated balance sheet as of March 31, 2011 was derived from the audited financial statements. These condensed consolidated financial statements and notes should be read in conjunction with the Company's consolidated financial statements for the year ended March 31, 2011, contained in the Company's annual report on Form 10-K as filed on June 23, 2011.

The accompanying consolidated condensed financial statements include the accounts of Cyanotech Corporation and its wholly owned subsidiary, Nutrex Hawaii, Inc. ( Nutrex Hawaii or Nutrex ). All significant intercompany balances and transactions have been eliminated in consolidation.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosures of contingent assets and liabilities at the balance sheet date and the reported amounts of revenues and expenses during the periods reported. Management reviews these estimates and assumptions periodically and reflects the effect of revisions in the period that they are determined to be necessary. Actual results could differ from those estimates and assumptions.

**2. INVENTORIES**

Inventories are stated at the lower of cost (which approximates first-in, first-out) or market. Market is defined as sales price less cost to dispose and a normal profit margin. Inventories consist of the following:

	September 30, 2011	March 31, 2011
	(in thousands)	
Raw materials	\$ 506	\$ 336
Work in process	256	339

## Edgar Filing: CYANOTECH CORP - Form 10-Q

Finished goods(1)	2,237	2,787
Supplies	189	165
	\$ 3,188	\$ 3,627

---

(1) Net of reserve for obsolescence of \$24,000 and \$148,000 at September 30, 2011 and March 31, 2011, respectively.

The Company recognizes abnormal production costs, including fixed cost variances from normal production capacity, as an expense in the period incurred. Approximately \$218,000 and \$416,000 of abnormal production costs were charged to cost of sales for the three and six months ended September 30, 2011. No abnormal production costs were charged to cost of sales for the three and six months ended September 30, 2010.

### 3. EQUIPMENT AND LEASEHOLD IMPROVEMENTS

Equipment and leasehold improvements are stated at cost. Depreciation and amortization are provided using the straight-line method over the estimated useful lives for equipment and furniture and fixtures, or the shorter of the land lease term or estimated useful lives for leasehold improvements as follows:

Equipment	3 to 10 years
Furniture and fixtures	7 years
Leasehold improvements	10 to 20 years

Table of Contents

Equipment and leasehold improvements consist of the following:

	September 30, 2011	March 31, 2011
	(in thousands)	
Equipment(1)	\$ 6,592	\$ 6,801
Leasehold improvements	7,394	7,367
Furniture and fixtures	119	95
	14,105	14,263
Less accumulated depreciation and amortization	(9,696)	(9,817)
Construction-in-progress	462	111
Equipment and leasehold improvements, net	\$ 4,871	\$ 4,557

(1) Includes \$97,000 of equipment under capital lease with accumulated amortization of \$29,000 and \$19,000 at September 30, 2011 and March 31, 2011, respectively.

The Company reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying value of such assets may not be recoverable. Recoverability of these assets is measured by a comparison of the carrying amount to forecasted undiscounted future cash flows expected to be generated by the asset. If the carrying amount exceeds its estimated future cash flows, then an impairment charge is recognized to the extent that the carrying amount exceeds the asset's fair value. Management has determined no asset impairment existed as of September 30, 2011 and 2010. The Company recognized a loss on disposal of equipment in the amount of \$62,000 and \$64,000 for the three and six months ended September 30, 2011, respectively. There was no disposal of assets for the three and six months ended September 30, 2010.

#### 4. ACCRUED EXPENSES

Accrued expenses consist of the following:

	September 30, 2011	March 31, 2011
	(in thousands)	
Wages, commissions	\$ 410	\$ 426
Customer rebates		173
Bonuses	296	100
Other accrued expenses	313	124
	\$ 1,019	\$ 823

#### 5. LINE OF CREDIT

The Company has a line of credit agreement with First Hawaiian Bank in the amount of \$350,000 with a maturity date of April 1, 2012. The obligation is secured by the Company's U.S. accounts receivable and bears a variable interest rate based on prime (3.25% at September 30, 2011)

## Edgar Filing: CYANOTECH CORP - Form 10-Q

plus 2%. There was no outstanding balance as of September 30, 2011 and March 31, 2011, respectively. The credit agreement requires the Company to meet certain financial covenants. The Company was in compliance with these financial covenants at September 30, 2011.

### 6. LONG-TERM DEBT

Long-term debt consists of the following:

	September 30, 2011	March 31, 2011
	(in thousands)	
Term loans	\$ 717	\$ 757
Less current maturities	(224)	(204)
Long-term debt, excluding current maturities	\$ 493	\$ 553

Table of Contents

*Term Loan Agreements*

In February 2008, the Company executed a Term Loan Agreement with a lender providing for \$1.1 million in aggregate credit facilities, secured by the Company's assets. The Term Loan has a maturity date of March 1, 2015 and is payable in 84 equal monthly principal payments plus interest. The interest rate under the Term Loan, in the absence of a default under the agreement, is the prime rate in effect as of the close of business on the first day of each calendar quarter, plus 1%. As of September 30, 2011, the prime rate was 3.25%. The balance under this loan was \$584,000 and \$660,000 at September 30, 2011 and March 31, 2011, respectively. The Company is prohibited from declaring any common stock dividends without the lender's prior written consent. The credit agreement requires the Company to meet certain financial covenants. The Company was in compliance with these financial covenants at September 30, 2011.

In March 2009, the Company executed a Term Loan Agreement with John Deere credit providing for \$29,000 in equipment, secured by the equipment financed. The Term Loan has a maturity date of March 25, 2013 and is payable in 48 equal monthly principal payments. The interest rate under this Term Loan is 0%. Imputed interest at a rate of 2% (cash discount offered by seller) has been recorded and will be amortized as interest over the term of the loan. The face value of the term loan is reported in the balance sheets at \$11,000, less the unamortized discount of \$1,000 at September 30, 2011 and \$15,000, less the unamortized discount of \$1,000 at March 31, 2011.

In January 2010, the Company executed a Term Loan Agreement with John Deere credit providing for \$30,000 in equipment, secured by the equipment financed. The Term Loan has a maturity date of December 28, 2012 and is payable in 36 equal monthly principal payments. The interest rate under this Term Loan is 0%. Imputed interest at a rate of 2% (cash discount offered by seller) has been recorded and will be amortized as interest over the term of the loan. The face value of the term loan is reported in the balance sheets at \$12,000, less the unamortized discount of \$500 at September 30, 2011 and \$17,000, less the unamortized discount of \$1,000 at March 31, 2011.

In June 2011, the Company executed a Term Loan Agreement with John Deere credit providing for \$43,000 in equipment, secured by the equipment financed. The Term Loan has a maturity date of May 25, 2015 and is payable in 48 equal monthly principal payments. The interest rate under this Term Loan is 0%. Imputed interest at a rate of 2% (cash discount offered by seller) has been recorded and will be amortized as interest over the term of the loan. The face value of the term loan is reported in the balance sheets at \$40,000, less the unamortized discount of \$1,500 at September 30, 2011.

In September 2011, the Company executed a Term Loan Agreement with Nissan Motor Acceptance Corporation providing for \$23,000 in equipment, secured by the equipment financed. The Term Loan has a maturity date of September 13, 2016 and is payable in 60 equal monthly principal payments. The interest rate under this Term Loan is 0%. Imputed interest at a rate of 2% (cash discount offered by seller) has been recorded and will be amortized as interest over the term of the loan. The face value of the term loan is reported in the balance sheets at \$23,000, less the unamortized discount of \$1,000 at September 30, 2011.

*Capital Lease*

In March 2010, the Company executed a capital lease agreement with Thermo Fisher Financial providing for \$97,000 in equipment, secured by the equipment financed. The capital lease has a maturity date of March 2013 and is payable in 36 equal monthly payments. The interest rate under this capital lease is 6.6%. The balance under this capital lease was \$51,000 at September 30, 2011 and \$67,000 at March 31, 2011.

Edgar Filing: CYANOTECH CORP - Form 10-Q

Future principal payments under the term loans and capital lease agreement as of September 30, 2011 are as follows:

<b>Payments Due</b>	<b>(in thousands)</b>	
Next 12 Months	\$	224
Year 2		203
Year 3		188
Year 4		102
Total principal payments	\$	717

Table of Contents**7. LEASES**

The Company leases facilities, equipment and land under operating leases expiring through 2026. The land lease provides for contingent rental in excess of minimum rental commitments based on a percentage of the Company's sales. Management has accrued for the estimated contingent rent as of September 30, 2011.

Future minimum lease payments under all non-cancelable operation leases at September 30, 2011 are as follows:

<b>Payments Due</b>	<b>(in thousands)</b>	
Next 12 Months	\$	239
Year 2		245
Year 3		248
Year 4		222
Year 5		147
Thereafter through 2026		1,369
Total minimum lease payments	\$	2,470

**8. SHARE-BASED COMPENSATION**

The Company accounts for transactions under share-based payment arrangements with employees based on fair value. Liability-classified awards are remeasured to fair value at each balance sheet date until the award is settled. The Company currently has no liability-classified awards. Equity-classified awards, including grants of employee stock options, are measured at the grant-date fair value of the award and are not subsequently remeasured unless an award is modified. The cost of share-based awards is recognized in the income statement over the period during which an employee is required to provide the service in exchange for the award, or the vesting period. All of the Company's stock options are service-based awards, and because the Company's stock options are plain vanilla, as defined by the U. S. Securities and Exchange Commission in Staff Accounting Bulletin No. 107, they are reflected only in Stockholders' Equity and Compensation Expense accounts.

*Stock Options*

The Company had the following two shareholder approved plans under which shares were available for equity based awards: the 2005 Stock Option Plan (the 2005 Plan) wherein 700,000 shares of common stock are reserved for issuance until the Plan terminates on August 21, 2015, and; the Independent Director Stock Option and Stock Grant Plan (the 2004 Directors Plan) wherein 75,000 shares of common stock are reserved for issuance until the plan terminates in 2014. The 2005 Plan was amended effective August 29, 2011, to increase the number of shares authorized for issue from 700,000 shares to 2,075,000 shares. The 2004 Directors Plan was amended effective August 29, 2011, to increase the number of shares authorized for issue from 75,000 shares to 200,000 shares. Both of these amendments were approved by the shareholders during the annual shareholders meeting held August 29, 2011.

## Edgar Filing: CYANOTECH CORP - Form 10-Q

Under the 2005 Plan, eligible employees and certain independent consultants may be granted options to purchase shares of the Company's common stock. The shares issuable under the 2005 Plan will either be shares of the Company's authorized but previously unissued common stock or shares reacquired by the Company, including shares purchased on the open market. As of September 30, 2011, there were 706,088 shares available for grant under the 2005 Plan.

Under the 2004 Directors Plan, upon election to the Board of Directors at an annual stockholders meeting, a newly elected non-employee director will be granted a ten-year option to purchase 1,000 shares of the Company's common stock. Options granted vest and become exercisable six months from the date of grant. In addition, on the date of each annual stockholders meeting, each non-employee director continuing in office is automatically issued 2,000 shares of the Company's common stock, and an additional 2,000 shares to the director serving as Chairman of the Board, non-transferable for six months following the date of grant. As of September 30, 2011, there were 153,123 shares available for grant under the 2004 Directors Plan. On November 8, 2011, the 2004 Directors Plan was amended and reformed to increase the number of options granted to newly elected non-employee directors from 1,000 shares to 6,000 shares.

## Edgar Filing: CYANOTECH CORP - Form 10-Q

### Table of Contents

The following table presents shares authorized, available for future grant and outstanding under each of the Company's plans:

	Authorized	As of September 30, 2011 Available	Outstanding
2005 Plan	2,075,000	706,088	1,233,816
2004 Directors Plan	200,000	153,123	2,000
1994 Plan			750
Total	2,275,000	859,211	1,236,566

All stock option grants made under the 2005 Plan and the 2004 Directors Plan were at exercise prices no less than the Company's closing common stock price on the date of grant. Options under the 2005 Plan and 2004 Directors Plan were determined by the Board of Directors or the Stock Option and Compensation Committee of the Board in accordance with the provisions of the respective plans. The terms of each option grant include vesting, exercise, and other conditions are set forth in a Stock Option Agreement evidencing each grant. No option can have a life in excess of ten (10) years under the respective plan. The Company records compensation expense for employee stock options based on the estimated fair value of the options on the date of grant using the Black-Scholes option-pricing model. The model requires various assumptions, including a risk-free interest rate, the expected term of the options, the expected stock price volatility over the expected term of the options, and the expected dividend yield. Compensation expense for employee stock options is recognized ratably over the vesting term. Compensation expense recognized for options issued under the 2005 Plan was \$115,000 and \$165,000 for the three and six months ended September 30, 2011, respectively. Compensation expense recognized for options issued under the 2005 Plan was \$7,000 and \$15,000 for the three and six months ended September 30, 2010, respectively. Independent Director compensation expense recognized for options issued under the 2004 Directors Plan was \$34,000 and \$21,000 for the three and six months ended September 30, 2011 and 2010, respectively. All share-based compensation has been classified as General and Administrative expense.

A summary of option activity under the Company's stock plans for the six months ended September 30, 2011 is presented below:

Option Activity	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at March 31, 2011	426,650	\$ 2.49		
Granted	867,516		3.78	
Exercised	(2,450)	\$ 2.35		
Forfeited	(54,400)	\$ 2.08		
Expired	(750)	\$ 4.20		
Outstanding at September 30, 2011	1,236,566	\$ 3.42	9.5 years	\$ 468,640
Exercisable at September 30, 2011	84,130	\$ 2.16	7.6 years	\$ 134,783

The aggregate intrinsic value in the table above is before applicable income taxes and represents the excess amount over the exercise price optionees would have received if all options had been exercised on the last business day of the period indicated, based on the Company's closing stock price of \$3.76 for such day.

A summary of the Company's non-vested options for the six months ended September 30, 2011 is presented below:

Edgar Filing: CYANOTECH CORP - Form 10-Q

<b>Nonvested Options</b>	<b>Shares</b>		<b>Weighted Average Grant-Date Fair Value</b>
Nonvested at March 31, 2011	377,040	\$	1.87
Granted	867,516		2.47
Vested	(38,280)		1.42
Forfeited or expired	(53,840)		1.12
Nonvested at September 30, 2011	1,152,436	\$	2.26

## Edgar Filing: CYANOTECH CORP - Form 10-Q

### Table of Contents

The following table summarizes the weighted average characteristics of outstanding stock options as of September 30, 2011:

Range of Exercise Prices	Number of Shares	Outstanding Options Remaining Life (Years)	Weighted Average Price	Number of Shares	Exercisable Options Weighted Average Price
\$ 1.41 - \$2.60	153,800	7.3	\$ 1.92	67,950	\$ 1.81
\$ 3.04 - \$4.40	1,082,766	9.8	3.63	16,180	3.63
Total stock options	1,236,566	9.4	\$ 3.42	84,130	\$ 2.16

There were 866,716 and 867,516 stock options granted during the three and six months ended September 30, 2011, respectively. No stock options were granted during the three and six months ended September 30, 2010. The value assumptions related to options granted during the six months ended September 30, 2011 were as follows:

	<b>2011</b>
Exercise Price:	\$ 3.58 - 3.82
Volatility:	56.18 - 78.46%
Risk Free Rate:	.19 - 2.25%
Vesting Period:	0 - 3 years
Forfeiture Rate:	0 - 5.54%
Expected Life	.25- 8.25 years
Dividend Rate	0%

As of September 30, 2011, total unrecognized share-based compensation expense related to all unvested stock options was \$2,033,000, which is expected to be expensed over a weighted average period of 4.7 years.

Subsequent to September 30, 2011, 10,000 stock options were granted from the 2004 Directors Plan and 45,000 stock options were granted from the 2005 Plan.

### ***Warrant***

At September 30, 2011 the Company had no warrants outstanding. At September 30, 2010, the Company had a single warrant outstanding which allowed the warrant holder rights to acquire 5,000 shares of the Company's common stock. The warrant was valued at the date of grant and was amortized as premium, but was subsequently deemed to have no value as a result of a reverse split which occurred in a prior year. Accordingly, no expense was recognized during the three and six months ended September 30, 2011 or 2010. The warrant expired in April 2011.

## **9. INCOME TAXES**

## Edgar Filing: CYANOTECH CORP - Form 10-Q

Income taxes are provided on the pretax income in the consolidated financial statements. The tax provision is based on the current quarter activity of the legal entities and jurisdictions in which the Company operates. Tax credits are recognized as a reduction to income taxes in the year the credits are earned, accordingly, the effective tax rate may vary from the customary relationship between income tax expense (benefit) and pretax income. The effective tax rate for the three and six months ended September 30, 2011 differs from the statutory rate due to utilization of net operating loss carryforwards that have been fully reserved due to the Company's inconsistent taxable income in recent years and uncertainty about taxable income in future years.

The Company is subject to taxation in the United States and two state jurisdictions. The preparation of tax returns requires management to interpret the applicable tax laws and regulations in effect in such jurisdictions, which could affect the amount of tax paid by the Company. Management, in consultation with its tax advisors, files its tax returns based on interpretations that are believed to be reasonable under the circumstances. The income tax returns, however, are subject to routine reviews by the various taxing authorities. As part of these reviews, a taxing authority may disagree with respect to the tax positions taken by management ( uncertain tax positions ) and therefore may require the Company to pay additional taxes. Management evaluates the requirement for additional tax accruals, including interest and penalties, which the Company could incur as a result of the ultimate resolution of its uncertain tax positions. Management reviews and updates the accrual for uncertain tax positions as more definitive information becomes available from taxing authorities, completion of tax audits, expiration of statute of limitations, or upon occurrence of other events.

As of September 30, 2011, there was no significant liability for income tax associated with unrecognized tax benefits. The Company recognizes accrued interest related to unrecognized tax benefits as well as any related penalties in interest income or expense in its consolidated condensed statements of operations, which is consistent with the recognition of these items in prior reporting periods.

With few exceptions, the Company is no longer subject to U.S. federal, state, local, and non-U.S. income tax examination by tax authorities for tax years before 2007.

Table of Contents**10. EARNINGS PER SHARE**

Basic earnings per share is computed on the basis of the weighted average number of common shares outstanding. Diluted earnings per share is computed on the basis of the weighted average number of common shares outstanding plus the potentially dilutive effect of outstanding stock options using the treasury stock method.

Reconciliations between the numerator and the denominator of the basic and diluted earnings per share computations for the three months ended September 30, 2011 and 2010 are as follows:

	Three Months Ended September 30, 2011		
	Net Income (Numerator)	Shares (Denominator)	Per Share Amount
	(in thousands)		
Basic income per share	\$ 875	5,398	\$ 0.16
Effect of dilutive securities - Common stock options		75	
	\$ 875	5,473	\$ 0.16

	Three Months Ended September 30, 2010		
	Net Income (Numerator)	Shares (Denominator)	Per Share Amount
	(in thousands)		
Basic income per share			
Effect of dilutive securities - Common stock options	\$ 526	5,374	\$ 0.10
Diluted income per share		16	
	\$ 526	5,390	\$ 0.10

Reconciliations between the numerator and the denominator of the basic and diluted earnings per share computations for the six months ended September 30, 2011 and 2010 are as follows:

	Six Months Ended September 30, 2011		
	Net Income (Numerator)	Shares (Denominator)	Per Share Amount
	(in thousands)		
Basic income per share	\$ 1,361	5,397	\$ 0.25
Effect of dilutive securities - Common stock options		74	
Diluted income per share	\$ 1,361	5,471	\$ 0.25

	Six Months Ended September 30, 2010		
	Net Income (Numerator)	Shares (Denominator)	Per Share Amount
	(in thousands)		
Basic income per share	\$ 925	5,314	\$ 0.17
Effect of dilutive securities - Common stock options		19	
Diluted income per share	\$ 925	5,333	\$ 0.17

Edgar Filing: CYANOTECH CORP - Form 10-Q

Diluted earnings per share does not include the impact of common stock options totaling 1,097,466 and 114,750 for the three months ended September 30, 2011 and 2010, respectively, and 1,098,266 and 114,917 for the six months ended September 30, 2011 and 2010, respectively, as the effect of their inclusion would be anti-dilutive.

Table of Contents

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

**FORWARD-LOOKING STATEMENTS**

This Report and other presentations made by Cyanotech Corporation ( CYAN ) and its subsidiaries contain forward-looking statements, which include statements that are predictive in nature, depend upon or refer to future events or conditions, and usually include words such as expects, anticipates, intends, plan, believes, predicts, estimates or similar expressions. In addition, any statement concerning future financial performance, ongoing business strategies or prospects and possible future actions are also forward-looking statements. Forward-looking statements are based upon current expectations and projections about future events and are subject to risks, uncertainties and the accuracy of assumptions concerning CYAN and its subsidiaries (collectively, the Company), the performance of the industry in which CYAN does business, and economic and market factors, among other things. **These forward-looking statements are not guarantees of future performance. Investors should not place undue reliance on forward-looking statements.**

Forward-looking statements speak only as of the date of the Report, presentation or filing in which they are made. Except to the extent required by the Federal Securities Laws, the Company undertakes no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. Our forward-looking statements in this Report include, but are not limited to:

- Statements relating to our business strategy;
- Statements relating to our business objectives; and
- Expectations concerning future operations, profitability, liquidity and financial resources.

These forward-looking statements are subject to risk, uncertainties and assumptions about us and our operations that are subject to change based on various important factors, some of which are beyond our control. The following factors, among others, could cause our financial performance to differ significantly from the goals, plans, objectives, intentions and expectations expressed in our forward-looking statements:

- The added risks associated with the current local, national and world economic crises, including but not limited to, the volatility of crude oil prices, inflation and currency fluctuations;
- The effects of competition, including locations of competitors and operating and market competition;

## Edgar Filing: CYANOTECH CORP - Form 10-Q

- Demand for the company's products, the quantities and qualities thereof available for sale and levels of customer satisfaction;
- Changes in domestic and/or foreign laws, regulations or standards, affecting nutraceutical products or the Company's methods of operation;
- Environmental restrictions, soil and water conditions, variations in daylight hours and seasonal weather patterns, particularly heavy rain, wind and other hazards;
- Access to available and reasonable financing on a timely basis;
- Changes in laws, including new corporate governance requirements and increased tax rates, regulations or accounting standards, and decisions of courts, regulators and governmental bodies;
- Our dependence on the experience, continuity and competence of our executive officers and other key employees;
- The risk associated with the geographic concentration of the company's business;
- Acts of war, terrorist incidents or natural disasters; and
- Other risks or uncertainties described elsewhere in this Report and in other periodic reports previously and subsequently filed by the Company with the Securities and Exchange Commission.

Table of Contents**Overview**

Comparisons of selected consolidated statements of operations data as reported herein follow for the periods indicated (dollars in thousands):

	<b>Three Months Ended</b>		<b>Change</b>
	<b>September 30, 2011</b>	<b>September 30, 2010</b>	
Net sales:			
Spirulina products	\$ 2,370	\$ 1,868	27%
Natural astaxanthin products	3,613	1,965	84%
Other products	6	1	600%
Total sales, all products	\$ 5,989	\$ 3,834	56%
Gross profit	\$ 2,790	\$ 1,652	69%
Income from operations	\$ 913	\$ 554	65%
Net income	\$ 875	\$ 526	66%

	<b>Six Months Ended</b>		<b>Change</b>
	<b>September 30, 2011</b>	<b>September 30, 2010</b>	
Net sales:			
Spirulina products	\$ 4,568	\$ 3,821	20%
Natural astaxanthin products	7,363	3,865	91%
Other products	8	4	200%
Total sales, all products	\$ 11,939	\$ 7,690	55%
Gross profit	\$ 4,894	\$ 3,311	48%
Income from operations	\$ 1,429	\$ 983	45%
Net income	\$ 1,361	\$ 925	47%

**Results of Operations***Second Quarter of Fiscal 2012 Compared to Second Quarter of Fiscal 2011*

Net sales for the second quarter of fiscal 2012 were \$5,989,000, a 56% increase from the \$3,834,000 reported for the comparable period a year ago. Spirulina sales increased 27% in the current quarter compared to last year due to a 20% increase in bulk sales and a 37% increase in packaged product sales. As a percentage of sales, spirulina accounted for 40% of total sales in the second quarter of fiscal 2012, compared to 49% for the comparable period a year ago.

Natural astaxanthin product sales increased 84% over the second quarter of the prior year due to a 74% increase in bulk product sales and a 108% increase in packaged product sales. Natural astaxanthin product sales increased to 60% of total sales from 51% of total sales in the second quarter of fiscal 2011.

## Edgar Filing: CYANOTECH CORP - Form 10-Q

International sales were 27% of total sales for the second quarter of fiscal year 2012 and 41% in the second quarter of 2011. The decrease in international sales as a percentage of total sales is due to the \$2,094,000 increase in domestic sales from the same period in the prior year. Major customers are those equaling or exceeding 10% of our sales for the period. There were no customers who had sales equaling or exceeding 10% of sales for the second quarter of 2012 and the comparable period of the prior year.

Gross profit, derived from net sales less the cost of product sales, includes the cost of materials, direct labor, manufacturing overhead, depreciation and abnormal production costs. Gross profit for the three months ended September 30, 2011 and 2010 was \$2,790,000 and \$1,652,000, respectively. The increase of \$1,138,000 is the direct result of increased sales and improved efficiency with regard to astaxanthin production. Gross profit margin, as a percentage of sales, was 47% for the three months ended September 30, 2011, compared to 43% for the comparable period in the prior year.

Variable production costs increased by 33% in the current period compared to one year ago. Increases in labor, nutrients, utilities, supplies and repair and maintenance costs were a result of efforts to increase production levels. Fixed costs have increased approximately 21% primarily due to depreciation expense associated with additions to production equipment and increased rent expense. Spirulina production decreased 2% and astaxanthin production increased 105% over the same quarter one year ago.

Operating expenses were \$1,877,000 in the three months ended September 30, 2011 compared to \$1,098,000 in the quarter ended September 30, 2010, an increase of \$779,000. As a percentage of sales, operating expenses were 31% in the quarter ended September 30, 2011 and 29% in the quarter ended September 30, 2010.

Table of Contents

The increase in operating expenses in the three months ended September 30, 2011 as compared with the three months ended September 30, 2010, was the result of increased general and administrative expense, sales and marketing expense, research and development expense and the loss on disposal of assets. General and administrative expense for the second quarter 2012 increased by \$474,000, up 74% from the second quarter of 2011. The increase is primarily the result of increased bonus, stock option compensation expense and recruiting costs. Sales and marketing expense for the second quarter of 2012 increased by \$216,000, up 55% from the second quarter of 2011. The increase is due primarily to increases in external commissions and new marketing and advertising programs for packaged products. Research and development expense for the second quarter of 2012 increased by \$27,000, up 44% from the second quarter of 2011. The increase is due primarily to increased employee compensation, lab supplies and outside services related to spirulina product usage.

We recorded income tax expense of \$28,000 and \$10,000 related to federal and state taxes for the three months ended September 30, 2011 and 2010, respectively. The company's effective tax rate was 3.29% and 2.01% for the three months ended September 30, 2011 and 2010, respectively. We do not expect any material U.S. federal income taxes to be recorded for the current fiscal year because of available net operating loss carry forwards. We do not expect to be able to utilize some of our state net operating loss carry forwards for the current fiscal year.

In summary, we reported net income of \$875,000 or \$0.16 per diluted share for the three months ended September 30, 2011 compared to net income of \$526,000 or \$0.10 per diluted share for the three months ended September 30, 2010. The increase is the result of increased sales and improved gross margin.

*Six Months Ended September 30, 2011 Compared to Six Months Ended September 30, 2010*

Net sales for the six months ended September 30, 2011 were \$11,939,000, an increase of 55% from sales of \$7,690,000 reported for the comparable period a year ago. The increase in sales over the prior year's six-month period was the result of a 20% increase in spirulina sales and a 91% increase in natural astaxanthin product sales. Spirulina bulk sales increased 10% while packaged spirulina products increased 36%. Astaxanthin bulk sales increased 84% while packaged astaxanthin product sales increased 108%. As a percentage of sales, spirulina accounted for 38% of total sales for the six months ended September 30, 2012, compared to 50% for the comparable period a year ago.

International sales represented 34% of net sales for the six months ended September 30, 2011 compared to 44% for the same period a year ago. For the six months ended September 30, 2011, there were no customers with sales equaling or exceeding 10% of our total sales. For the six months ended September 30, 2010, one customer had sales equal to or greater than 10% of our total sales.

Gross profit for the six months ended September 30, 2011 and September 30, 2010 was \$4,894,000 and \$3,311,000 respectively. The increase of \$1,583,000 is the direct result of increased sales. Gross profit margin, as a percentage of sales, was 41% for the six months ended September 30, 2011, compared to 43% for the comparable period in the prior year.

For the six months ended September 30, 2011, variable production costs increased 25%. Increases in labor, nutrients, utilities, supplies and repair and maintenance costs were a result of efforts to increase production levels. Fixed costs have increased approximately 21% primarily due to depreciation expense associated with additions to production equipment and increased rent expense. Spirulina production decreased 18% and astaxanthin production increased 86% over the same six month period one year ago.

## Edgar Filing: CYANOTECH CORP - Form 10-Q

Operating expenses for the six months ended September 30, 2011 were \$3,465,000, an increase of \$1,137,000 or 49% from the comparable prior year period. General and administrative expense increased \$659,000 or 47%. The increase is primarily the result of increased bonus, stock option compensation expense and recruiting costs. Sales and marketing expense increased by \$400,000 or 52% as a result increases in external commissions and new marketing and advertising programs for packaged products designed to expand consumer awareness. Research and development expense increased \$14,000 or 10% from the comparable prior period, primarily due to increased employee compensation, lab supplies and outside services related to spirulina product usage.

For the six months ended September 30, 2011, we recorded income tax expense of \$44,000 related to federal and state taxes, compared to \$20,000 for the six months ended September 30, 2010. The company's effective tax rate was 3.31% and 2.12% for the six months ended September 30, 2011 and 2010, respectively. We do not expect any material U.S. federal income taxes to be recorded for the current fiscal year because of available net operating loss carry forwards. We do not expect to be able to utilize some of our state net operating loss carry forwards for the current fiscal year.

We reported net income of \$1,361,000 or \$0.25 per diluted share for the six month period ended September 30, 2011. For the same period a year ago we reported net income of \$925,000 or \$0.17 per diluted share.

Table of Contents

**Variability of Results**

We have experienced significant quarterly fluctuations in operating results and such fluctuations could occur in future periods. We have, during our history, experienced fluctuations in operating results due to the following: changes in sales levels to our customers; competition including pricing, new products and shifts in market trends; production difficulties from environmental influences; increased production costs and variable production results due to inclement weather; and start up costs associated with new product introductions, new facilities and expansion into new markets. In addition, future operating results may fluctuate as a result of factors beyond our control such as foreign exchange fluctuations, changes in government regulations, and economic changes in the regions we have customers. A portion of our operating expenses are relatively fixed and the timing of increases in expense levels is based in large part on forecasts of future sales. Therefore, if net sales are below expectations in any given period, the adverse impact on results of operations may be magnified by our inability to effectively adjust spending in certain areas, or to adjust spending in a timely manner, as in personnel and administrative costs. We may also choose to reduce prices or increase spending in response to market conditions, and these decisions may have a material adverse effect on financial condition and results of operations.

**Financial Condition**

Cash and cash equivalents increased by \$2,029,000, or 98% from March 31, 2011 to \$4,091,000 at September 30, 2011. Cash provided by operating activities of \$2,779,000 increased \$2,765,000 from the same six month period of last fiscal year. The increase is due to the increase in net income of \$436,000, plus the increase of non-cash expenses of \$293,000 and the net change in working capital providing cash of \$2,036,000 over the same six month period of last fiscal year. The net change in current assets and liabilities was largely due to decreased inventory and receivables, and increases in payables and accrued expenses.

As of September 30, 2011, our accounts receivable, net decreased \$117,000 to \$2,524,000 from \$2,641,000 as of March 31, 2011. The decrease in accounts receivable is primarily the result of the timing of sales to some large bulk customers for the quarter. Management believes that its accounts receivable are collectible, net of the allowance for doubtful accounts of \$58,000, at September 30, 2011.

Our net inventory decreased \$439,000 or 12% to \$3,188,000 as of September 30, 2011 compared to \$3,627,000 as of March 31, 2011. The decrease in inventory during the first six months of fiscal 2012 is primarily due to the increase in sales.

Total current liabilities increased \$360,000 or 16% to \$2,556,000 as of September 30, 2011 compared to \$2,196,000 as of March 31, 2011. The increase is mainly due to increased vendor activity in support of the higher sales volume and higher bonus accrual.

Net cash used in investing activities increased by \$659,000 over the same six month period of last fiscal year primarily due to the completion of improvements and acquisition of property plant and equipment, and the return of restricted cash in the amount of \$250,000 that occurred in the prior year. Cash flows used in investing activities reflect capital expenditures which totaled \$716,000 during the first six months of fiscal 2012 compared to \$307,000 one year ago.

## Edgar Filing: CYANOTECH CORP - Form 10-Q

Cash flows used in financing activities are attributable to debt payments during that period which were \$105,000 and \$176,000 for the first six months of fiscal 2012 and 2011, respectively.

### Liquidity and Capital Resources

At September 30, 2011, our working capital was \$7,489,000, an increase of \$1,204,000 compared to \$6,285,000 at March 31, 2011. The increase in working capital is primarily due to the increase in cash, offset by an increase in current liabilities. Cash and cash equivalents at September 30, 2011 totaled \$4,091,000, an increase of \$2,029,000 from \$2,062,000 at March 31, 2011.

The Company has a Term Loan with a lender providing up to \$1.1 million in credit, which is secured by substantially all the assets of the Company. The outstanding balance under the Term Loan as of September 30, 2011 is approximately \$584,000 with a maturity date of March 1, 2015 and is payable in equal monthly principal payments plus interest totaling approximately \$15,000. The interest rate under the Term Loan, in absence of a default under the agreement, is the prime rate, as defined, in effect as of the close of business on the first day of each calendar quarter, plus 1% (the prime rate was 3.25% at September 30, 2011). We are prohibited by the Term Loan from declaring any common stock dividends without the lender's prior written consent.

The Company has a line of credit agreement with First Hawaiian Bank in the amount of \$350,000 with a maturity date of April 1, 2012. The obligation is secured by the Company's U.S. accounts receivable and bears a variable interest rate based on prime (3.25% at September 30, 2011) plus 2%. There was no outstanding balance as of September 30, 2011 and March 31, 2011, respectively. The credit agreement requires the Company to meet certain financial covenants. The Company was in compliance with these financial covenants at September 30, 2011.

Table of Contents

We have, as previously reported, experienced a number of factors that have negatively impacted our balance sheet and liquidity. At September 30, 2011, we had an accumulated deficit of \$15,439,000 compared to an accumulated deficit of \$16,800,000 at March 31, 2011. The accumulated deficit decreased by \$1,361,000 for the six months ended September 30, 2011.

***Sufficiency of Liquidity***

Based upon our current operating plan, analysis of our consolidated financial position and projected future results of operations, we believe that our operating cash flows, cash balances, and working capital, together with a moderate amount of additional borrowing, will be sufficient to finance current operating requirements, debt service requirements, and planned capital expenditures, for the next twelve (12) months. We expect liquidity in the remainder of fiscal 2012 to be generated from operating cash flows.

**Capital Resources**

We expect fiscal 2012 capital expenditures to be approximately \$1,500,000 and to be funded from operating cash flows. This includes capital expenditures in support of our normal operations, and expenditures that we may incur in conjunction with initiatives to improve gross margins and reduce expenses.

**Outlook**

*This outlook section contains a number of forward-looking statements, all of which are based on current expectations. Actual results may differ materially.*

Our strategic direction has been to position the Company as a world leader in the production and marketing of high-value natural products from microalgae. We are vertically aligned, producing raw materials in the form of microalgae processed at our 90-acre facility in Hawaii, and integrating those raw materials into finished products. In fiscal 2012, our primary focus will be to put a scalable foundation in place, improving our processes, systems, facilities and organization. We will continue putting increased emphasis on our Nutrex Hawaii consumer products to introduce them to a broader consumer market than in prior years. Our focus going forward will continue to be to leverage our experience and reputation for quality, building nutritional brands which promote health and well-being. The foundation of our nutritional products is naturally cultivated Hawaiian Spirulina Pacifica® in powder and tablet form; and BioAstin® Hawaiian Astaxanthin antioxidant in extract, softgel caplet and micro-encapsulated beadlet form. Responding to the increased market demand of astaxanthin products, the Company announced that it will be increasing its astaxanthin production capacity by 33%. The project is expected to be fully on line within six months. Information about our Company and our products can be viewed at [www.cyanotech.com](http://www.cyanotech.com) and [www.nutrex-hawaii.com](http://www.nutrex-hawaii.com). Consumer products can also be purchased online at [www.nutrex-hawaii.com](http://www.nutrex-hawaii.com).

We are focused on sustainability of production levels in order to promote growth in our astaxanthin and spirulina product lines. We will continue to improve and expand this line to meet the demand of consumers. We will continue to promote the nutritional superiority of Hawaiian grown spirulina to maintain and expand market share. Significant sales variability between periods and even across several periods can be expected

based on historical results.

Rising crude oil prices in prior years resulted in increased nutrient, utility and transportation costs which reflect and respond to oil prices. We feel that these conditions are likely to continue and/or reoccur from time to time in the future, and consequently, we are putting greater focus on prudent cost controls and expense avoidance.

Gross profit margin percentages going forward will be impacted by continued pressure on input costs and greater competition in the market place. This could cause margins to decline in future periods. We will continue to focus on health and well-being, promoting higher gross margin items. We are dedicated to continuous improvements in process and production methods to stabilize and increase production levels for the future.

Producing the highest quality microalgae is a complex biological process which requires balancing numerous factors including microalgal strain variation, temperature, acidity, nutrient and other environmental considerations, some of which are not within our control. An imbalance or unexpected event can occur resulting in production levels below normal capacity. The allocation of fixed production overheads (such as depreciation, rent and general insurance) to inventories is determined based on normal production capacity. When our production volumes are below normal capacity limits, certain fixed production overhead costs cannot be inventoried and are recorded immediately in cost of sales. In addition, when production costs exceed historical averages, we evaluate whether such costs are one-time-period charges or an ongoing component of inventory cost.

Table of Contents

To manage our cash resources effectively, we will continue to balance production in light of sales demand, minimizing the cost associated with build-ups in inventory when appropriate. We could experience unplanned cash outflows and may need to utilize other cash resources to meet working capital needs. A prolonged downturn in sales could impair our ability to generate sufficient cash for operations and minimize our ability to attract additional capital investment which could become necessary in order to expand facilities, enter into new markets or maintain optimal production levels.

Our future results of operations and the other forward-looking statements contained in this Outlook, in particular the statements regarding revenues, gross margin and capital spending, involve a number of risks and uncertainties. In addition to the factors discussed above, any of the following could cause actual results to differ materially: business conditions and growth in the natural products industry and in the general economy; changes in customer order patterns; changes in demand for natural products in general; changes in weather conditions; competitive factors, such as increased production capacity from competing spirulina and astaxanthin producers and the resulting impact, if any, on world market prices for these products; government actions and increased regulations both domestic and foreign; shortage of manufacturing capacity; and other factors beyond our control. Risk factors are discussed in detail in Item 1A in our Form 10-K report for the year ended March 31, 2011.

We believe that our technology, systems, processes and favorable growing location generally permit year-round harvest of our microalgal products in a cost-effective manner. However, previously experienced imbalances in the highly complex biological production systems, together with volatile energy costs and rapidly changing world markets, suggest a need for continuing caution with respect to variables beyond our reasonable control. Therefore, we cannot, and do not attempt to, provide any definitive assurance with regard to our technology, systems, processes, location, or cost-effectiveness.

**Item 3. Quantitative and Qualitative Disclosures about Market Risk**

We do not enter into any transactions using derivative financial instruments or derivative commodity instruments and believe that our exposure to market risk associated with other financial instruments is not material.

We have one term loan which adjusts quarterly based on the prime rate, and one revolving line of credit which adjust upon change of the prime rate. As such, we are exposed to the interest rate risk whereby a 1% increase in the prime rate would lead to an increase of approximately \$6,000 in interest expense for the year ending March 31, 2012 (based on September 30, 2011 amounts outstanding).

**Item 4. Controls and Procedures**

**(a) Disclosure Controls and Procedures**

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

## Edgar Filing: CYANOTECH CORP - Form 10-Q

timely decisions regarding required disclosure. On August 17, 2011 the Company announced the appointment of a new Chief Financial Officer, Jole Deal.

This Form 10-Q should be read in conjunction with Item 9A Controls and Procedures of the Company's Form 10-K for the fiscal year ended March 31, 2011, filed June 23, 2011. There were no material changes in controls and procedures during the current quarter. As of September 30, 2011, management believes systems and procedures were in place to reasonably ensure accurate financial data.

As noted in prior years' Forms 10-K, errors were identified in the calculations and applications of certain accounting practices relating to the carrying value of inventory. Throughout the years subsequent to the identification of the weakness, management has continuously added measures to improve and evaluate the effectiveness of controls over financial reporting. These measures include: upgrades and improvements to the Company's resource management system; automation of manual functions within the resource management system, through the use of interfacing add-on applications and through software application that manage critical data independently; subscription to an online knowledgebase to provide the latest updates and checklists of accounting and reporting standards; additional accounting personnel and system training. Based on these measures, management believes systems and procedures are in place to reasonably ensure accurate financial data. However, we continue to rely on a highly manual process involving a number of spreadsheets used in the valuation of inventory, and we have been unable to completely remediate the internal control deficiencies noted in the past.

Table of Contents

**(b) Changes to Internal Control Over Financial Reporting**

There was no change in our internal control over financial reporting during the current quarter that has materially affected or is reasonably likely to materially affect, our internal control over financial reporting. In order to address the material weakness identified in the prior years, we are continuously making changes in our accounting procedures and processes. These changes, designed to improve our internal controls, relate to proper accounting for inventory costs in accordance with GAAP and with internal control over financial reporting. However, our agricultural production processes are susceptible to adverse weather conditions and environmental influences that can impact the results on a period to period basis. Accordingly, judgments and separate manual analyses are required to properly allocate costs to inventory and will likely continue to be required. Due to the knowledge and experience of our personal, we believe systems and procedures are in place to reasonably ensure accurate financial data.

**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

None.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

None.

**Item 3. Defaults upon Senior Securities**

None.

**Item 5. Other Information**

a) An updated Audit Committee Charter has been posted on the Company's website: [www.cyanotech.com](http://www.cyanotech.com) under Investors and the link Corporate Governance.

b) In addition to stock option grants under the Company's 2005 Stock Option Plan to the Company's Chief Executive Officer (CEO) in accordance with the terms of his employment and to the Company's Chief Financial Officer (CFO) in accordance with the terms of her employment (both of which were reported in Form 8-K filings), three other named executive officers were awarded stock options on August 29, 2011, following stockholder approval of a Plan amendment which added 1,375,000 shares to be reserved for issuance under the Plan on August 29, 2011. The additional shares were needed to meet the Company's contract obligations to its new CEO and CFO, as well as its existing and projected needs to reward other executive officers and employees over the remaining term of the Plan. All stock option grants are subject to the terms of the Plan and a stock option agreement required to be executed by each grantee. The Plan is attached hereto as Exhibit 10.2.

i) Gerald R. Cysewski, Ph.D., a director and Executive Vice President and Chief Scientific Officer, was awarded 103,000 stock options of which 300 became exercisable on August 29, 2011; 20,600 will become exercisable on August 29, 2012; 20,900 will become exercisable on August 29, 2013; 21,200 on August 29, 2014; 20,000 will become exercisable on August 29, 2015; and 20,000 will become exercisable on

## Edgar Filing: CYANOTECH CORP - Form 10-Q

August 29, 2016. In each instance the grant price was \$3.82 per share.

ii) Glenn D. Jensen, Vice President Operations, was awarded 37,000 stock options of which 200 became exercisable on August 29, 2011; 7,400 will become exercisable on August 29, 2012; 7,600 will become exercisable on August 29, 2013; 7,800 will become exercisable on August 29, 2014; 7,000 will become exercisable on August 29, 2015; and 7,000 will become exercisable on August 29, 2016. In each instance the grant price was \$3.82 per share.

iii) Robert J. Capelli, Vice President Sales, was awarded 27,000 stock options of which 200 became exercisable on August 29, 2011; 5,400 will become exercisable on August 29, 2012; 5,600 will become exercisable on August 29, 2013; 5,800 will become exercisable on August 29, 2014; 5,000 will become exercisable on August 29, 2015; and 5,000 will become exercisable on August 29, 2016. In each instance the grant price was \$3.82 per share.

Table of Contents

**Item 6. Exhibits**

a) The following exhibits are furnished with this report:

- 10.1 2004 Independent Director Stock Option and Restricted Stock Grant Plan, amended and restated November 8, 2011.
- 10.2 2005 Stock Option Plan, amended August 29, 2011.
- 31.1 Certifications of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 signed as of November 14, 2011
- 31.2 Certifications of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 signed as of November 14, 2011.
- 32 Certifications of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 signed as of November 14, 2011.
- 101 The following financial statements from Cyanotech Corporation's Quarterly Report on Form 10-Q for the quarter ended September 30, 2011, formatted in XBRL (eXtensible Business Reporting Language): (i) the Condensed Consolidated Balance Sheets, (ii) the Condensed Consolidated Statements of Operations, (iii) the Condensed Consolidated Statements of Cash Flows, and (iv) Notes to Condensed Consolidated Financial Statements.

Table of Contents

SIGNATURES

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

CYANOTECH CORPORATION  
(Registrant)

November 14, 2011  
(Date)

By:

/s/ Brent D. Bailey  
Brent D. Bailey  
*President and Chief Executive Officer and Director*

November 14, 2011  
(Date)

By:

/s/ Jole Deal  
Jole Deal  
*Vice President Finance & Administration and CFO  
(Principal Financial and Accounting Officer)*

Table of Contents

EXHIBIT INDEX

<b>Exhibit Number</b>	<b>Description</b>
10.1	2004 Independent Director Stock Option and Restricted Stock Grant Plan, amended and restated November 8, 2011.
10.2	2005 Stock Option Plan, amended August 29, 2011.
31.1	Certifications of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 signed as of November 14, 2011
31.2	Certifications of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 signed as of November 14, 2011.
32	Certifications of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 signed as of November 14, 2011.
101	The following financial statements from Cyanotech Corporation's Quarterly Report on Form 10-Q for the quarter ended September 30, 2011, formatted in XBRL (eXtensible Business Reporting Language): (i) the Condensed Consolidated Balance Sheets, (ii) the Condensed Consolidated Statements of Operations, (iii) the Condensed Consolidated Statements of Cash Flows, and (iv) Notes to Condensed Consolidated Financial Statements.