CYANOTECH CORP
Form 10-Q
March 14, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

Quarterly Report Under Section 13 or 15(d)
of the Securities Exchange Act of 1934

For Quarterly Period Ended December 31, 2006

Commission File Number 0-14602

CYANOTECH CORPORATION

(Exact name of registrant as specified in its charter)

NEVADA	**91-1206026**
(State or other jurisdiction of incorporation or organization)	(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)

Check whether the registrant (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act 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 x No o

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

Large accelerated filer o Accelerated filer o Non-accelerated filer x

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

Number of common shares outstanding as of March 1, 2007:

Title of Class	Shares Outstanding
Common stock - $0.02 par value	5,233,543

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Explanatory Note Restatement of Financial Information

On December 1, 2006, Cyanotech Corporation (the Company) filed a Current Report on Form 8-K with the Securities and Exchange Commission (SEC) announcing that it would be restating certain consolidated financial statements in amendments to its annual report on Form 10-K/A for the fiscal year ended March 31, 2006. As more fully described in Note 13 to the Consolidated Financial Statements in Form 10-K/A filed February 14, 2007, the Company identified errors in the application of certain accounting practices and procedures. The restatement and filing of Form 10-K/A was primarily the result of the Company s failure to include as a component of inventory cost certain fixed production costs such as depreciation, general insurance and minor compensation cost. All inventories, cost of sales and operating expense balances, as presented in this Form 10-Q, properly reflect the inclusion of these fixed production costs in accordance with Accounting Research Bulletin No. 43. In addition, the restatement and filing of Form 10-K/A also included adjustments for certain Hawaii State Tax Credits and interest income for the years ended March 31, 2004 and 2003, and tax adjustments for the years ended March 31, 2006, 2005, 2004, and 2003, all of which where considered immaterial in prior years. In addition, refundable income taxes were restated for each of the years in the three year period ended March 31, 2006 and the reclassification of certain certificates of deposit from cash to short-term investments in fiscal years 2005 and 2004. These reclassifications had no effect on reported net income (loss) or in cash flow from operations. The foregoing adjustments and reclassifications are, where appropriate, reflected in the comparative restated information presented in this Form 10-Q.

The Company is filing this Form 10-Q for the fiscal quarter ended December 31, 2006. Restated amounts from the consolidated balance sheet, as of March 31, 2006, and the statement of operations and consolidated statement of cash flows for the three and nine months ended December 31, 2005 are included in this filing. The Company will not file a Form 10-Q/A for the quarterly period ended December 31, 2005, and the consolidated financial statements and related information contained in that report should no longer be relied upon.

On November 3, 2006, the Company implemented a one for four stock split at which time the share price closed at $0.43 with 20,934,565 common shares outstanding. As the stock split occurred during the fiscal quarter reported by this Form 10-Q, and prior to the issuance of the financial statements, all share data and per share data in these financial statements and notes to financial statements reflect the effect of the split.

This Form 10-Q should be read in conjunction with the Company s Form 10-K/A for the fiscal year ended March 31, 2006 filed February 14, 2007. Prior period comparative information contained in this Form 10-Q has been restated consistent with the Company s Form 10-K/A and to reflect the Company s one-for-four reverse stock split (see Notes 2 and 3 of Notes to Consolidated Financial Statements included in the Form 10-Q).

The Company did not file Form 10-K/A, for the fiscal years 2005 or 2004, or Form 10-Q/A, for the interim periods affected by the restatement prior to and including December 31, 2005. The consolidated financial statements and related financial information for such periods as previously filed, contain errors and should therefore no longer be relied upon. The related audit reports for the years ended March 31, 2005 and 2004 of KPMG LLP, the Company s independent registered public accounting firm, with respect to those financial statements should also no longer be relied upon.

Potential Delisting of Our Common Stock From Nasdaq Capital Market Trading. See Risk Factors Part II, Item 1A herein.

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PART 1. FINANCIAL INFORMATION

Item 1. Financial Statements

CYANOTECH CORPORATION
CONSOLIDATED BALANCE SHEETS
(Dollars in thousands)
(Unaudited)

	December 31, 2006	**March 31, 2006 (As Restated)**
ASSETS		
Current assets:		
Cash and cash equivalents	$ 1,306	$ 1,835
Short-term investments	700	700
Accounts receivable, net	1,519	2,209
Refundable income taxes	27	17
Inventories (see Note 4)	1,797	2,056
Prepaid expenses and other current assets	219	99
Total current assets	5,568	6,916
Equipment and leasehold improvements, net (see Note 5)	9,451	10,164
Other assets	441	515
Total assets	$ 15,460	$ 17,595
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Current maturities of long-term debt	$ 364	$ 364
Accounts payable	638	485
Accrued expenses	511	420
Total current liabilities	1,513	1,269
Long-term debt, excluding current maturities (see Note 6)	1,119	1,387
Total liabilities	2,632	2,656
Stockholders equity (see Notes 2 and 3):		
Common Stock of $0.02 par value; shares authorized 7,500,000; 5,233,543 shares issued and outstanding at December 31, 2006 and 5,232,066 at March 31, 2006	105	105
Additional paid-in capital	27,333	27,330
Accumulated other comprehensive income - foreign currency translation adjustments	(9)	(1)
Accumulated deficit	(14,601)	(12,495)
Total stockholders equity	12,828	14,939
Total liabilities and stockholders equity	$ 15,460	$ 17,595

See accompanying Notes to Consolidated Financial Statements.

CYANOTECH CORPORATION
CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share amounts)
(Unaudited)

	Three Months Ended December 31, 2006	Three Months Ended December 31, 2005 (As Restated)	Nine Months Ended December 31, 2006	Nine Months Ended December 31, 2005 (As Restated)
NET SALES	$ 2,434	$ 2,333	$ 7,353	$ 7,879
COST OF PRODUCT SALES	2,356	1,674	6,400	5,633
Gross profit	78	659	953	2,246
OPERATING EXPENSES:				
Research and development	81	44	161	140
Sales and marketing	327	347	942	975
General and administrative	833	444	1,866	1,367
Total operating expenses	1,241	835	2,969	2,482
Loss from operations	(1,163)	(176)	(2,016)	(236)
OTHER INCOME (EXPENSE):				
Interest income	12	13	38	36
Interest expense	(46)	(46)	(140)	(136)
Other income (expense), net	7	(2)	3	(10)
Total other expense, net	(27)	(35)	(99)	(110)
Loss before income taxes	(1,190)	(211)	(2,115)	(346)
INCOME TAX (BENEFIT) EXPENSE	(3)	(1)	(9)	2
NET LOSS	$ (1,187)	$ (210)	$ (2,106)	$ (348)
NET LOSS PER SHARE (see Note 7)				
Basic	$ (0.23)	$ (0.04)	(0.40)	$ (0.07)
Diluted	$ (0.23)	$ (0.04)	(0.40)	$ (0.07)
SHARES USED IN CALCULATION OF NET LOSS PER SHARE:				
Basic	5,234	5,226	5,234	5,225
Diluted	5,234	5,226	5,234	5,225
COMPREHENSIVE LOSS:				
Net loss	$ (1,187)	$ (210)	(2,106)	$ (348)
Other comprehensive loss	(8)	(17)	(8)	(25)
	$ (1,195)	$ (227)	$ (2,114)	$ (373)

See accompanying Notes to Consolidated Financial Statements.

CYANOTECH CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Dollars in thousands)
(Unaudited)

	Nine Months Ended December 31, 2006	2005 (As Restated)
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$ (2,106)	$ (348)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	959	1,019
Provision for (reduction of) allowance for doubtful accounts	4	(5)
Issuance of stock options in exchange for services		14
Amortization of debt issue costs and other assets	27	27
Net (increase) decrease in:		
Accounts receivable	686	629
Refundable income taxes	(10)	46
Inventories	259	(536)
Prepaid expenses and other assets	(81)	(89)
Net increase (decrease) in:		
Accounts payable	153	(529)
Accrued expenses	91	180
Net cash provided by (used in) operating activities	(18)	408
CASH FLOWS FROM INVESTING ACTIVITIES:		
Investment in equipment and leasehold improvements	(246)	(203)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from exercise of stock options and warrants	3	
Principal payments on long-term debt	(268)	(259)
Net cash used in financing activities	(265)	(259)
Net decrease in cash and cash equivalents	(529)	(54)
Cash and cash equivalents at beginning of period	1,835	2,005
Cash and cash equivalents at end of period	$ 1,306	$ 1,951
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid during the period for:		
Interest	$ 118	$ 101
Income taxes	$ 1	$ 4

See accompanying Notes to Consolidated Financial Statements.

CYANOTECH CORPORATION
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
As of December 31, 2006
(Unaudited)

1. BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. Generally Accepted Accounting Principles (GAAP) for interim financial information and with the instructions to Form 10-Q and Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. *These consolidated financial statements and notes should be read in conjunction with the Company s consolidated financial statements contained in the Company s previously filed report on Form 10-K/A for the year ended March 31, 2006.*

The Company consolidates enterprises in which it has a controlling financial interest. The accompanying consolidated financial statements include the accounts of Cyanotech Corporation and its wholly owned subsidiaries, Nutrex Hawaii, Inc. and Cyanotech Japan YK. All significant intercompany balances and transactions have been eliminated in consolidation. While the financial information furnished for the three and nine month period ended December 31, 2006 is unaudited, the statements in this report reflect all material items and adjustments which, in the opinion of management, are necessary for a fair presentation of the results of operations for the interim periods covered and of the financial condition of the Company at the dates of the consolidated balance sheets. The operating results for the interim period presented are not necessarily indicative of the results that may be expected for the year ending March 31, 2007.

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 period 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. REVERSE STOCK SPLIT

On September 15, 2006 the Company s Board of Directors approved a one-for-four reverse stock split on our outstanding common stock and a proportional decrease in the number of common shares authorized from 30,000,000 to 7,500,000. The reverse stock split was effective on November 3, 2006 at which time the share price closed at $0.43 with 20,934,565 common shares outstanding. On November 6, 2006, the share price opened at $1.72 with 5,233,641 common shares outstanding resulting from the reverse stock split with the expectation that most stockholders of common stock will not exchange their shares as such exchange is not mandatory and stockholders may keep the originally issued shares for exchanged value. Fractional shares were paid with cash totaling less than $1,000. The long term future impact of the reverse stock split on the Company s stock price is uncertain.

The reverse stock split decision by the Board of Directors was taken to bring the outstanding shares of common stock in line with the Company s size and value and to bring the price of such stock into compliance with the Nasdaq listing requirement of at least $1.00 per share. The Company had been notified by Nasdaq that it was subject to delisting for failure of the stock to trade at $1.00 per share or above. On November 20, 2006, the Company received a letter from Nasdaq indicating the closing bid price of its common stock had been at $1.00 per share or greater for at least 10 consecutive business days. Accordingly, the Company regained compliance with Marketplace Rule 4310(c)(4).

As the stock split occurred during the current fiscal quarter ended December 31, 2006, all share option data and per share data in these financial statements and notes to the financial statements reflect the effects of the stock split as if it occurred for all periods presented.

3. STOCK-BASED COMPENSATION

Effective April 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standard No. 123(R) (SFAS No. 123R), Share-Based Payment, for its share-based compensation plans, which is a revision of Statement of Financial Accounting Statement No. 123 Accounting for Stock-Based Compensation . On March 29, 2005, the SEC staff issued Staff Accounting Bulletin No. 107, Share-Based Payment (SAB No. 107), which expressed the SEC staff s views on SFAS No. 123R, but did not modify any of SFAS No. 123R s provisions. SFAS No. 123R requires an entity to measure the cost of employee services received in exchange for an award. If an award vests or becomes exercisable based on the achievement of a condition other than service, performance or market condition, the award is liability-classified. Liability-classified awards are remeasured to fair value at each balance sheet date until the award is settled. Equity-classified awards, including grants of employee stock options, are measured at the

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grant-date fair value of the award and are not subsequently remeasured. The cost of equity-classified 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. In the Company s case, all of the Company s stock options are equity-classified awards.

Under the 2005 Stock Option Plan (the 2005 Plan), 200,000 shares of common stock are reserved for issuance and the plan terminates on August 21, 2015. Under the 2005 Plan, eligible employees and certain independent consultants may be granted options to purchase shares of the Company s 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 December 31, 2006, 195,000 options remained available for grant under the 2005 Plan. Concurrent with the 2005 Plan approval on August 22, 2005, the 1995 Stock Option Plan was terminated except for the outstanding options issued thereunder.

Options under the 2005 Plan are granted, and are vested and exercisable as determined by the Board of Directors or the Stock Option and Compensation Committee of the Board in accordance with the provisions of the 2005 Stock Option Plan. The number of options granted, 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. All shares granted in the form of options under the 2005 Plan will reduce, on a share for share basis, the number of shares available for subsequent grants. Option grants which forfeit under the terms of the 2005 Plan will return to the pool of reserved shares and be available for subsequent grants under the terms of the 2005 Plan.

SFAS No. 123R offers several alternatives for implementation, among them the Modified Prospective Method of accounting for compensation costs related to Share Based Payments which the Company has determined to apply. In the Company s case, its employee incentive stock options are plain vanilla as defined by the SEC is SAB No. 107, normally vesting over a five year period and exercisable under the terms of the Company s Stock Plan up to ten years from date of grant. Because the Company s future employee incentive stock options are expected to be plain vanilla , they will be reflected only in Equity and Compensation Expense accounts. The Company has determined that a Black-Scholes-Merton model will be most reflective of the fair value of option grants, consistent with the provisions of SFAS No. 123R and SAB No. 107. Key input and assumptions used to estimate the fair value of stock options include the grant price of the award, the expected option term, volatility of the Company s stock, risk-free rate and the Company s dividend yield. Estimates of fair value are not intended to predict actual future events or the value ultimately realized by employees who receive equity awards and subsequent events are not indicative of the reasonableness of the original estimates of fair value made by the Company.

There is no unrecognized compensation cost related to nonvested stock options as of December 31, 2006. Currently outstanding nonvested options are options that were granted to non-employees and the compensation cost for these options was recognized in prior years operating results. There are no nonvested employee options because, on March 23, 2006, in response to SFAS No. 123R, the Compensation and Stock Option Committee of the Company s Board of Directors approved accelerating the vesting of all outstanding unvested employee incentive stock options under the provisions of APB Opinion No. 25, and related interpretations. Options held by non-employees and directors were not included in the vesting acceleration. The decision to accelerate vesting of all outstanding unvested employee incentive stock options was made to avoid recognizing, pursuant to the Company s April 1, 2006 adoption of SFAS No. 123R, the non-cash compensation cost related to unvested employee incentive stock options. It is estimated that the total future compensation expense that was avoided by accelerating vesting was $78,000, before tax, based upon the March 23, 2006 acceleration date. A portion of this amount would have impacted the three and nine months ended December 31, 2006 had the acceleration not occurred. No options were granted by the Company during the nine month period ending December 31, 2006. Had any options been granted, related compensation expense under the provisions of SFAS No. 123R would have been reflected in the Consolidated Statements of Operations.

The Independent Director Stock Option and Stock Grant Plan (the 2004 Plan) has 75,000 shares of common stock are reserved for issuance. Under the 2004 Plan, upon election to the Board of Directors, a newly elected non-employee director is granted a ten-year option to purchase 1,000 shares of the Company s common stock at a fair market value on the date of grant. All such options are granted at fair market value on the date of grant. Options granted vest and become exercisable six months from the date of grant. In addition, on the date of each Annual Meeting of Stockholders, each non-employee director continuing in office is automatically granted, without payment, 875 shares of common stock, non-transferable for six months following the date of grant. As of December 31, 2006, 69,500 options remained available for grant under the 2004 Plan. Concurrent with the 2004 Plan approval on August 16, 2004, the 1994 Non-Employee Director Stock Option and Stock Grant Plan was terminated except for the outstanding options issued thereunder.

The following table summarizes the weighted average characteristics of outstanding stock options as of December 31, 2006 for various exercise price ranges:

	Outstanding Options			Exercisable Options	
Range of Exercise Prices	Number of Shares	Remaining Life (Years)	Weighted Average Price	Number of Shares	Weighted Average Price
$1.84-$3.08	50,944	1.7	$ 2.18	50,757	$ 2.18
$3.88-$6.75	26,978	2.8	4.51	25,978	4.52
$14.75-$24.50	7,000	1.2	15.80	7,000	15.80
Total stock options at December 31, 2006	84,922		4.04	83,735	4.05

A summary of option activity under Cyanotech Corporation Stock Plans for the quarter ended December 31, 2006 is presented below:

Option Activity	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at September 30, 2006	94,037	$ 3.94	2.1 years	
Granted				
Exercised				
Forfeited or expired	(9,115)	$ 3.01		
Outstanding at December 31, 2006	84,922	$ 4.04	2.0 years	$ 343,085
Exercisable at December 31, 2006	83,735	$ 4.05	2.0 years	$ 339,127

A summary of Cyanotech Corporation s non-vested options for the quarter ended December 31, 2006 is presented below:

Nonvested Options	Shares	Weighted Average Grant-Date Fair Value
Nonvested at September 30, 2006	1,936	$ 3.85
Granted		
Vested		
Forfeited or expired	(749)	$ 3.61
Nonvested at December 31, 2006	1,187	$ 4.00

A summary of option activity under Cyanotech Corporation Stock Plans for the nine months ended December 31, 2006 is presented below:

Option Activity	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at March 31, 2006	117,230	$ 3.91	2.3 years	
Granted				
Exercised	(1,575)	$ 2.15		
Forfeited or expired	(30,733)	$ 3.61		
Outstanding at December 31, 2006	84,922	$ 4.04	2.0 years	$ 343,085
Exercisable at December 31, 2006	83,735	$ 4.05	2.0 years	$ 339,125

A summary of Cyanotech Corporation s non-vested options for the nine months ended December 31, 2006 is presented below:

Nonvested Options	**Shares**	**Weighted Average Grant-Date Fair Value**
Nonvested at March 31, 2006	2,953	$ 3.98
Granted		
Vested		
Forfeited or expired	(1,766)	$ 3.96
Nonvested at December 31, 2006	1,187	$ 4.00

Prior to April 1, 2006, as allowed by Statement of Financial Accounting Standards No. 123 (SFAS No. 123), Accounting for Stock-Based Compensation*,* the Company elected to apply the intrinsic value-based method of accounting for employee based stock options and adopted only the disclosure requirements of SFAS No. 123. The following table illustrates the effect on net loss and net loss per common share as if the Company had applied the fair-value method under SFAS No. 123 to its employee stock options for the three and nine month comparable periods ended December 31, 2005:

	Three Months Ended December 31, 2005 (As Restated)	Nine Months Ended December 31, 2005 (As Restated)
Net loss, as reported	$ (210)	$ (348)
Deduct stock-based employee compensation		
Expense determined under fair-value method for all awards	(5)	(44)
Pro-forma net loss	$ (215)	$ (392)
Basic net loss per common share:		
As reported	$ (0.04)	$ (0.07)
Pro-forma	$ (0.04)	$ (0.08)
Diluted net loss per common share:		
As reported	$ (0.04)	$ (0.07)
Pro-forma	$ (0.04)	$ (0.08)

Options were exercised during the nine month period ending December 31, 2006. The intrinsic value of options exercised during the nine months ended December 31, 2006 was $1,000. The amount of cash received from option exercises during the nine months ended December 31, 2006 was $3,000. Because qualified employee incentive options were exercised and the Company has significant operating loss carry forwards, there were no tax consequences as a result of option exercises during the nine months ended December 31, 2006.

4. 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 (dollars in thousands):

	December 31, 2006	March 31, 2006 (As Restated)
Raw materials	$ 230	$ 240
Work in process	281	260
Finished goods	1,142	1,432
Supplies	144	124
	$ 1,797	$ 2,056

5. 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

Equipment and leasehold improvements consist of the following (dollars in thousands):

	December 31, 2006	March 31, 2006 (As Restated)
Equipment	$ 10,700	$ 10,461
Leasehold improvements	14,666	14,642
Furniture and fixtures	86	86
	25,452	25,189
Less accumulated depreciation and amortization	(16,286)	(15,327)
Construction in-progress	285	302
Equipment and leasehold improvements, net	$ 9,451	$ 10,164

6. TERM LOAN AGREEMENT COVENANTS WAIVER

The Company s long-term debt consists of a Term Loan Agreement (Term Loan) with a lender providing for $3.5 million in aggregate credit facilities, secured by the Company s assets. The Term Loan contains restrictive covenants. The Company obtained a waiver of the debt covenants that may not be in compliance as a result of the restatement of previously issued financial statements and as related to the untimely submission of its quarterly financial statements for the first quarter ended June, 30, 2006 , and the second quarter ended September 30, 2006 (see Note 9) and has also obtained a separate waiver of the debt covenants that may not be in compliance as a result of the untimely submission of its quarterly financial statements for the third quarter ended December 31, 2006.

7. 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 and warrants using the treasury stock method and convertible securities using the if-converted method.

Reconciliations between the numerator and the denominator of the basic and diluted earnings per share computations for the three months ended December 31, 2006 and 2005 are as follows (in thousands, except per share amounts):

	Three Months Ended December 31, 2006			Three Months Ended December 31, 2005 (As Restated)		
	Net Loss (Numerator)	Shares (Denominator)	Per Share Amount	Net Loss (Numerator)	Shares (Denominator)	Per Share Amount
Basic net loss per share	$ (1,187)	5,234	$ (0.23)	$ (210)	5,226	$ (0.04)
Effect of dilutive securities Common stock options and warrants						
Diluted net loss per share	$ (1,187)	5,234	$ (0.23)	$ (210)	5,226	$ (0.04)

Reconciliations between the numerator and the denominator of the basic and diluted earnings per share computations for the nine months ended December 31, 2006 and 2005 are as follows (in thousands, except per share amounts):

	Nine Months Ended December 31, 2006			Nine Months Ended December 31, 2005 (As Restated)		
	Net Loss (Numerator)	Shares (Denominator)	Per Share Amount	Net Loss (Numerator)	Shares (Denominator)	Per Share Amount
Basic net loss per share	$ (2,106)	5,234	$ (0.40)	$ (348)	5,225	$ (0.07)
Effect of dilutive securities Common stock options and warrants						
Diluted net loss per share	$ (2,106)	5,234	$ (0.40)	$ (348)	5,225	$ (0.07)

The following securities were excluded from the calculation of diluted earnings per share because their effect was antidilutive (in thousands):

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2006	2005	2006	2005
Stock options and warrants	89	128	89	128

8. NEW ACCOUNTING PRONOUNCEMENTS

In November 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 151 (SFAS No. 151) Inventory Costs an Amendment of Accounting Research Bulletin No. 43, Chapter 4 . SFAS No. 151 requires that abnormal amounts of freight, handling costs and wasted material (spoilage) be recognized as current-period charges and fixed production overhead costs be allocated to inventory based on the normal capacity of production facilities. Normal capacity is defined as the production expected to be achieved over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance . Companies will no longer be permitted to capitalize inventory costs on the balance sheet when the production defect rate varies significantly from the expected defect rate. The Company adopted SFAS No. 151 effective April 1, 2006. In accordance with SFAS No. 151 fixed production related costs of $181,000 or $0.03 per diluted share were not inventoried for the three months ended December 31, 2006, and fixed production related costs of $275,000 or $0.05 per diluted share were not inventoried for the nine months ended December 31, 2006. The costs were not inventoried due to production below normal capacity.

In December 2004, the FASB issued SFAS No. 153, Exchange of Nonmonetary Assets, an amendment of APB Opinion No. 29, Accounting for Nonmonetary Transactions . SFAS No. 153 is based on the principle that exchange of nonmonetary assets should be measured based on the fair market value of the assets exchanged. SFAS No. 153 eliminates the exception of nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. SFAS No. 153 is effective for nonmonetary asset exchanges in fiscal periods beginning after June 15, 2005. The Company adopted SFAS No. 153 effective April 1, 2006. Adoption of the provisions of SFAS No. 153 had no material impact on the Company s financial condition, results of operations, or liquidity.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20 and FASB Statement No. 3 . SFAS No. 154 requires retrospective application for voluntary changes in accounting principle unless it

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is impracticable to do so. In addition, indirect effects of a change in accounting principle should be recognized in the period of the accounting change. The Company adopted SFAS No. 154 effective April 1, 2006. Because the impact of adopting the provisions of SFAS No. 154 will be dependent on future events or circumstances, management cannot predict such impact.

In June 2006, the FASB issued FASB Interpretation No. 48 (FIN No. 48), Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109 . This interpretation prescribes a more-likely-than-not recognition threshold and measurement attribute (the largest amount of benefit that is greater than 50% likely of being realized upon ultimate settlement with tax authorities) for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN No. 48 is effective for fiscal years beginning after December 15, 2006. The Company will adopt FIN No. 48 on April 1, 2007 and has not yet determined the impact of these provisions on the Company s results of operations, financial condition or liquidity.

In June 2006, the FASB ratified the consensus on Emerging Issues Task Force Issue No. 06-3 (EITF No. 06-3), How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement . The scope of EITF No. 06-3 includes any tax assessed by a governmental authority that is directly imposed on a revenue-producing transaction between a seller and a customer and may include, but is not limited to, sales, use, value added, Universal Service Fund (USF) contributions and some excise taxes. The Task Force affirmed its conclusion that entities should present these taxes in the income statement on either a gross or a net basis based on their accounting policy, which should be disclosed pursuant to APB Opinion No. 22, Disclosure of Accounting Policies. If such taxes are significant and are presented on a gross basis, the amounts of those taxes should be disclosed. The consensus on EITF No. 06-3 will be effective for interim and annual reporting periods beginning after December 15, 2006. The Company adopted EITF No. 06-3 on January 1, 2007 and has elected to present these taxes on a gross basis consistent with its accounting policy and historical treatment. For future periods after January 1, 2007, if material, the Company will disclose such taxes.

On September 13, 2006, the SEC issued Staff Accounting Bulletin No. 108 (SAB No. 108), Considering the Effects of Prior Year Misstatements when Quantifying Misstatements of Current Year Financial Statements which expresses the SEC s views regarding the process of quantifying financial statement misstatements. SAB No. 108 provides guidance on the consideration of the effects of prior year misstatements (misstatements that were not corrected at the end of the prior year) in quantifying current year misstatements for the purpose of a materiality assessment. Common practice in quantifying a misstatement allows for multiple approaches. A misstatement can be based on the amount of the error originating in the current year income statement or be based on the effects of correcting the misstatement existing in the balance sheet at the end of the current year, irrespective of the misstatement s year(s) of origination. Therefore, in quantifying the impact of correcting all misstatements, including both the carryover and reversing effects of prior year misstatements, on the current year financial statements, errors should be measured under each approach and evaluated for materiality. An adjustment would be required when either approach results in quantifying a misstatement that is material, as defined in FASB Concepts Statement No. 2, after considering all relevant quantitative and qualitative factors. SAB No. 108 is effective for fiscal years ended after November 15, 2006. Because the impact of adopting the provisions of SAB No. 108 will be dependent on future events or circumstances, management cannot predict such impact.

On September 15, 2006, the FASB issued SFAS No. 157, Fair Value Measurement (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The Company is evaluating the impact of adopting SFAS 157 on the Company s consolidated financial position, results of operations and cash flows.

In September 2006 the Financial Accounting Standards Board Issued: Statement No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106, and 132(R). An employer with publicly traded equity securities is required to initially recognize the funded status of a defined benefit postretirement plan and to provide the required disclosures as of the end of the fiscal year ending after December 15, 2006. The Company does not maintain any Defined Benefit Pension and Other Postretirement Plans, and Statement No. 158 is currently not applicable.

In February 2007 the Financial Accounting Standards Board issued SFAS No. 159 The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115. The Statement permits entities to choose to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. The Statement is expected to expand the use of fair value measurement, which is consistent with the Board s long-term measurement objectives for accounting for financial instruments. The Statement is effective

as of the beginning of an entity s first fiscal year that begins after November 15, 2007. Early adoption is permitted as of the beginning of a fiscal year that begins on or before November 15, 2007, provided the entity also elects to apply the provisions of FASB Statement No. 157, Fair Value Measurements. Since Cyanotech Corporation is not subject to volatility in its financial instruments, which consist only of long term mortgage debt and bank issued certificate of deposits, the Statement is not currently applicable to the Company.

9. RESTATEMENT OF PREVIOUSLY ISSUED CONSOLIDATED FINANCIAL STATEMENTS; LISTING STATUS

On December 1, 2006, Cyanotech Corporation filed a Current Report on Form 8-K with the SEC announcing that based on the current findings of its previously announced accounting review, it had determined to restate certain of its previously issued financial statements. Since that time, we completed our accounting review and determined that certain of the errors resulted from deficiencies in our internal control over financial reporting. See Part I. Item 4 Controls and Procedures in this Form 10-Q and Item 9A Controls and Procedures in Form 10-K/A filed February 14, 2007. Due to the inventory valuation issues involved and the time and effort required for completion of the restatement reflected in the Form 10-K/A, the Company was delinquent in the filing of its Form 10-Q for the periods ended June 30 and September 30, 2006.

On December 18, 2006, the Company received a Determination Letter (the Letter) from the Nasdaq Listing Qualifications Hearings Panel (the Panel). In its letter, the Panel granted, subject to certain conditions, the Company s request for continued listing on the Nasdaq Stock Market. The Panel determined that the Company would have until February 20, 2007 to file its Form 10-Q for the quarter ended June 30, 2006, its Form 10-Q for the quarter ended September 30, 2006, and its Form 10-K/A restatement. The Company filed its Form 10-K/A on February 14, 2007, and filed its Forms 10-Q for the periods ended June 30 and September 30, 2006 on February 20, 2007. The Company filed an appeal on February 20, 2007 with the Nasdaq Listing and Review Council of the Panel s determination requesting a stay of the delisting of its common stock until February 28, 2007. However, after filing of the Forms 10-Q, Nasdaq notified the Company that it had satisfied the conditions of the December 18, 2007 Panel Determination. Subsequently, Cyanotech Corporation received notice on February 21, 2007 from The NASDAQ Stock Market that the Company is not in Compliance with Nasdaq Marketplace Rule 4310(c)(14 for failure to file its Form 10-Q for the period ended December 31, 2006 and that such failure is basis for delisting the Company s Common Stock from The Nasdaq Stock Market. The Company was granted until February 28, 2007 to present its views to the Nasdaq Listing Qualifications Panel with respect to the failure to file such Form 10-Q. In its response the Company indicated that it expected to file the Form 10-Q report on or before March 14, 2007 and requested continued listing. On February 28, 2007, based on its response and request for continued listing submitted by the Company to Nasdaq, the Company received notice that the Nasdaq Listing Qualifications Panel has determined to grant the Company s request for continued listing subject primarily to the Company s filing on or before March 14, 2007 its Form 10-Q for the period ended December 31, 2006. In addition, the Company must be able to demonstrate compliance with all requirements for continued listing. As of the time of filing this report, the Company believes it meets all of the requirements for continued listing stated in the Listing Qualifications Panel determination of February 28, 2007. However, if the Company is incorrect in its belief, and the Company s common stock is delisted, our stockholders could be materially and adversely affected by having less active and efficient market available for the trading of their stock.

The Company s Form 10-K/A for the fiscal years ended March 31, 2006 and 2005 amended and restated the:

(1) consolidated balance sheets as of March 31, 2006 and 2005;

(2) consolidated statements of operations, stockholder s equity and comprehensive income (loss) and cash flows for each of the years in the three year period ended March 31, 2006;

(3) accumulated deficit as of March 31, 2003;

(4) selected financial data for the years ended March 31, 2006, 2005, 2004, 2003 and 2002; and

(5) certain financial data for the quarterly periods ended March 31, 2006, and December 31, September 30, June 30, and March 31, 2005 and December 31, September 30, and June 30, 2004.

The errors or adjustments identified in our previously issued consolidated financial statements are as follows:

(A) *We failed to include as a component of inventory cost certain fixed production costs such as depreciation, general insurance and minor compensation cost into inventory.* Inventories for March 31, 2006, 2005, 2004 and 2003, and quarterly periods within the years 2006 and 2005, were restated as were cost of sales and certain operating expenses as included in the Consolidated Statements of Operations for each of the years in the three year period ended

March 31, 2006. This restatement was a result of the discovery of the error subsequent to the filing with the SEC of the Original Form 10-K as filed with the SEC. All inventories, cost of sales and operating expense balances, as presented in this Form 10-Q, properly reflect the inventory which includes these fixed production costs in accordance with Accounting Research Bulletin No. 43.

(B) We recorded certain Hawaii State Tax Credit adjustments which were considered immaterial in prior years. Refundable income taxes were restated for the year ended March 31, 2005. Income tax expense (benefit) was restated for each of the years in the three year period ended March 31, 2006 but had no impact on net loss for the three and nine months ended December 31, 2006 and 2005.

(C) We recorded certain interest income adjustments which were considered immaterial in prior years. These impacted the years ended March 31, 2004 and 2003 but had no impact on the three and nine months ended December 31, 2006 and 2005.

(D) We reclassified certain certificates of deposit from cash to short-term investments in fiscal years 2005 and 2004. These reclassifications had no effect on reported net income (loss) or in cash flows from operations for the years ended March 31, 2005 and 2004. Cash flows from operations for the three and nine months ended December 31, 2005 were restated.

(E) We recorded certain tax adjustments which were considered immaterial to reports filed in prior periods. These adjustments impacted the years ended March 31, 2005, 2004 and 2003. Cash flows from operations for the three and nine months ended December 31, 2005 were restated.

Quarterly data has been derived from our unaudited consolidated financial statements that, in our opinion, reflect all recurring adjustments necessary to fairly present our financial information when read in conjunction with our Consolidated Financial Statements and Notes. This quarterly information has been restated for, and as of the end of, all quarters of fiscal 2006 and all quarters of fiscal 2005 from previously reported information filed on Forms 10-Q and Forms 10-K, as a result of the restatement of our financial results as discussed above. The results of operations for any quarter are not necessarily indicative of the results to be expected for any future period.

The following tables set forth the amounts previously reported in the Company s consolidated statements of operations for the three month period ended December 31, 2005 and the nine month period ended December 31, 2005 and the effect of the restatement adjustments, and the restated amounts.

(in thousands, except per share data)	Consolidated Statement of Operations Three Months Ended December 31, 2005 (As reported)	Adjustments	Three Months Ended December 31, 2005 (As restated)
Net sales	$ 2,333	$	$ 2,333
Cost of sales (A)	1,712	(38)	1,674
Gross profit	621	38	659
Operating expenses:			
Research and development (A)	45	(1)	44
Sales and marketing (A)	351	(4)	347
General and administrative (A)	461	(17)	444
Total operating expense	857	(22)	835
Income (loss) from operations	(236)	60	(176)
Other income (expense):			
Interest income	13		13
Interest expense	(46)		(46)
Other income, net	(2)		(2)
Total other expense, net	(35)		(35)
Income (loss) before income taxes	(271)	60	(211)
Income tax expense (benefit) (B, E)	23	(24)	(1)
Net income (loss)	$ (294)	$ 84	$ (210)
Net income (loss) per share:			
Basic	$ (0.06)	$ 0.02	$ (0.04)
Diluted	$ (0.06)	$ 0.02	$ (0.04)
Shares used in calculation of net income (loss) per share:			
Basic	5,226		5,226
Diluted	5,226		5,226

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(in thousands, except per share data)	Consolidated Statement of Operations Nine Months Ended December 31, 2005 (As reported)	Adjustments	Nine Months Ended December 31, 2005 (As restated)
Net sales	$ 7,879	$	$ 7,879
Cost of sales (A)	5,652	(19)	5,633
Gross profit	2,227	19	2,246
Operating expenses:			
Research and development (A)	144	(4)	140
Sales and marketing (A)	988	(13)	975
General and administrative (A)	1,421	(54)	1,367
Total operating expense	2,553	(71)	2,482
Income (loss) from operations	(326)	90	(236)
Other income (expense):			
Interest income	36		36
Interest expense	(136)		(136)
Other income, net	(10)		(10)
Total other expense, net	(110)		(110)
Income (loss) before income taxes	(436)	90	(346)
Income tax expense (benefit) (B, E)	26	(24)	2
Net income (loss)	$ (462)	$ 114	$ (348)
Net income (loss) per share:			
Basic	$ (0.09)	$ 0.02	$ (0.07)
Diluted	$ (0.09)	$ 0.02	$ (0.07)
Shares used in calculation of net income (loss) per share:			
Basic	5,225		5,225
Diluted	5,225		5,225

CYANOTECH CORPORATION

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

This report on Form 10-Q contains forward-looking statements regarding the future performance of Cyanotech and future events that involve risks and uncertainties that could cause actual results to differ materially from the statements contained herein. This document, and the other documents that the Company files from time to time with the Securities and Exchange Commission, such as its reports except those of which have been designated as no longer to be relied upon on Form 10-K/A, Form 10-K, Form 10-Q, Form 8-K, and its proxy materials, contain additional important factors that could cause actual results to differ from the Company s current expectations and the forward-looking statements contained herein.

Restatement of Previously Issued Consolidated Financial Statements

On December 1, 2006, the Company filed a Current Report on Form 8-K with the SEC in which it announced that based on current findings of its previously announced accounting review it had determined to restate certain of its previously issued financial statements. Since that time, the Company completed its accounting review and has determined that certain of the errors resulted from deficiencies in internal control over financial reporting. See Item 9A. Controls and Procedures in the Company s Form 10-K/A filed on February 14, 2007. The Company did not file Form 10-K/A, for the fiscal years 2005 or 2004, or Form 10-Q/A, for the interim periods affected by the restatement prior to and including December 31, 2005, and such consolidated financial statements and related financial information, as previously filed, contain errors and should therefore no longer be relied upon. The related audit reports of KPMG LLP, the Company s independent registered public accounting firm, with respect to those financial statements should also no longer be relied upon. Prior period comparative information contained in this form 10-Q has been restated consistent with the Company s Form 10-K/A and to reflect the Company s one-for-four reverse stock split as discussed under Item 1A Risk Factors sub heading Market Price for Our Common Stock *of the Form 10-K/A..*

Overview

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

	Three Months Ended December 31, 2006			Three Months Ended December 31, 2005 (As Restated)			Change	
Net sales:								
Spirulina products	$	1,475		$	1,307		13	%
Natural astaxanthin products	950			994			(4	)%
Other products	9			32			(72	)%
Total sales, all products	$	2,434		$	2,333		4	%
Gross profit	$	78		$	659		(88	)%
Loss from operations	$	(1,163	)	$	(176	)	561	%
Net loss	$	(1,187	)	$	(210	)	465	%
Net sales:								
Spirulina products	$	4,437		$	4,512		(2	)%
Natural astaxanthin products	2,840			3,193			(11	)%
Other products	76			174			(56	)%
Total sales, all products	$	7,353		$	7,879		(7	)%
Gross profit	$	953		$	2,246		(58	)%
Loss from operations	$	(2,016	)	$	(236	)	754	%
Net loss	$	(2,106	)	$	(348	)	505	%

Sales for the three and nine months ended December 31, 2006 increased $101,000 or 4% and decreased $526,000 or 7% from the comparable three and nine month periods of the prior year, respectively. For the three month period, Spirulina sales increased 13% above the comparable prior year period due to increased unit sales of bulk products to larger customers. Natural astaxanthin sales decreased 4% from the comparable prior year period with increased packaged product unit sales offset by decreased astaxanthin prices resulting from volume discounts and competitive pricing requirements.

For the nine month period ended December 31, 2006, natural astaxanthin sales decreased $353,000 or 11% and Spirulina sales decreased $75,000 or 2% from the comparable nine month prior year period. The decrease in natural astaxanthin sales for the nine month period was primarily due to decreased bulk product, including NatuRose, unit sales, and decreased average bulk selling prices. Both of these overshadowed increased packaged astaxanthin and spirulina unit sales and prices.

For the three and nine months ended December 31, 2006, the Company s cost of sales increased $682,000 or 41% and $767,000 or 14%, with respect to the prior comparable periods, Total cost of sales for the three and nine months ended December 31, 2006 was 97% and 87% of net sales, compared to 72% and 71%, with respect to the prior comparable periods. Correspondingly, for the three and nine month periods ended December 31, 2006 gross profit decreased to 3% and 13% from 28% and 29% in the comparable prior year periods.

The cost of sales increase for the three months ended December 31, 2006, relative to the prior comparable period, was primarily due to labor and chemical costs, some of which were deemed to be period costs resulting from an abnormal usage of nutrients which, coupled with other efforts, were not effective in correcting an imbalance in the multiple factors affecting the Company s biological cultivation process. Comparable period labor costs increased due to hourly wage rate increases in the first quarter of the year, and also due to the additional effort required in light of the just mentioned imbalance. The imbalance also required the Company to incur additional utility costs relative to the level of product produced. In general, the forgoing elements combined to significantly increase the cost of sales, and correspondingly reduce gross profit for the three months ended December 31, 2006 relative to the prior comparable period. The cost of sales increase for the nine months ended December 31, 2006 relative to the prior comparable nine months was mainly due to the aforementioned factors, with imbalance in the cultivation process, and attendant additional efforts and costs, more of a factor in the third quarter. The impact of the imbalance is discussed, in part, below, and in more detail later in this *Overview.*

During the three and nine months ended December 31, 2006, as part of cost of sales, the Company recorded non inventoriable costs of approximately $513,000 and $1,276,000 respectively. Comparable non-inventoriable costs recognized in the three and nine months ended December 31, 2005 were $193,000 and 471,000, respectively, with non-inventoriable costs increasing $320,000 and $805,000 for the three and nine month periods ended December 31, 2006. The three months ended December 31, 2006 included an increase of $284,000 of period costs resulting from the abnormal chemical, labor, and utility usage discussed above, and $105,000 wherein a portion of otherwise inventoriable fixed costs could not be inventoried due to natural astaxanthin production output below normal capacity. The nine months ended December 31, 2006 included an increase of $434,000 of period costs due to abnormal chemical, labor, and utility usage. In addition, during the nine month period there was an increase of $295,000 in production costs associated with the Company s animal nutrition market products which were not inventoriable because such costs would have exceeded the market value for such inventory. Additional information on these costs is provided later in this report.

We expect that the Company s gross profit margins during fiscal 2007, and during the first quarter of fiscal 2008, will continue to be less than the margins reported for comparable prior year periods. This is primarily due to increased operating costs, the need to price competitively, and actions underway to bring production to desired capacity and quality levels. As noted earlier, the Company has recognized period costs resulting from an abnormal usage of nutrients coupled with other efforts which were not effective in correcting an imbalance in the cultivation process. Producing the highest quality microalgae is a complex biological process which requires the tenuous balancing of numerous factors including microalgal strain variations, temperature, acidity, nutrient and other environmental considerations, some of which is not in the Company s control. As a result, especially for natural astaxanthin cultivation, it is difficult and time consuming to adjust, improve or correct the production process when quality levels fall below specifications, and, while the Company possesses the scientific knowledge and resources to correct its production processes, there are too many variables involved for the Company to make reliable projections concerning such efforts.

Operating expenses, compared to the comparable prior year period, increased $406,000 or 49% for the three months and $487,000 or 20% for the nine months ended December 31, 2006. The increase was primarily due to efforts associated with the restatement and filing process of the Company s Form 10-K/A as well as late filings of Forms 10-Q and the related fees for accounting, legal, auditing and contract services. $427,000 of such costs were incurred during the three months ended December 31, 2006, and $480,000 of such costs were incurred during the nine months then ended.

Other expenses decreased slightly comparing both the three and nine month periods ended December 31, 2006 and 2005.

The loss in gross profit and higher operating expenses resulted in a net loss of $1,187,000 for the third quarter of fiscal 2007, compared to a net loss of $210,000 for the third quarter of the prior fiscal year, and a loss of $2,106,000 for the nine months ended December 31, 2006 compared to a loss of $348,000 for the nine months ended December 31, 2005.

Results of Operations

Third Quarter of Fiscal 2007 Compared to Third Quarter of Fiscal 2006

Net sales for the three months ended December 31, 2006 were $2,434,000, a 4% increase from $2,333,000 for the comparable period a year ago. The increase was primarily from increased sales of spirulina products partially offset by decreased natural astaxanthin sales in comparison to the prior comparable period. Sales of spirulina products for the third quarter of fiscal 2007 were $1,475,000, an increase of 13% over the $1,307,000 generated in the third quarter of fiscal 2006. As a percentage of sales, Spirulina represented 61% of total sales in the current period and 56% of sales in the prior comparable period. Natural astaxanthin product sales were $950,000 during the third quarter of fiscal 2007, a 4% decrease from $994,000 in the third quarter of the prior year. Natural astaxanthin product lines decreased to 39% of total sales compared to 43% of total sales in the third quarter of fiscal 2006. Natural astaxanthin sales continued to decrease both as a result of a shortage of natural astaxanthin production and due to continued lower NatuRose demand in the Japanese aquaculture market. Had production been at levels consistent with prior consecutive quarters, the Company believes it could have would have generated additional sales in all natural astaxanthin products. This belief, however, is not based on a firmly contracted backlog since the Company s customers may at any time forgo purchases or seek alternative sources.

Other product sales, primarily phycobilli proteins, were $9,000 and $32,000 for the third quarter of fiscal years 2007 and 2006, respectively, and represented 0.4% and 1% of sales in the respective periods.

International sales were 44% of total sales for the third quarter of fiscal 2007 and the comparable third quarter of fiscal 2006. Historically, our major customers (sales exceeding 10% of total sales) have been two distributors, one based in Europe and one in the United States. For the three months ended December 31, 2006, neither distributor accounted for more than 10% of total sales. For the three months ended December 31, 2005, sales to the United States distributor were 12% of total sales.

For the three months ended December 31, 2006, the Company s cost of sales increased $682,000 or 41% with respect to the prior comparable period. The cost of sales increase was primarily due to increased chemical and labor costs. For the three months ended December 31, 2006, total variable production costs increased 3%, and units produced decreased 35%, resulting in higher costs per unit of production. Chemical costs increased as a result of increased consumption of nutrients some of which were deemed to be period costs resulting from an abnormal usage of nutrients coupled with other efforts which were not effective in correcting an imbalance in the cultivation process. Labor costs were impacted by wage increases during the first quarter of fiscal 2007 in response to a competitive labor market (primarily from the construction industry) in Hawaii.

The foregoing cost increases, coupled with the 35% decrease in units produced, contributed to the Company recording additional otherwise inventoriable costs as expenses in the current period. Such costs totaled approximately $529,000 in three months ended December 31, 2006 compared to $90,000 for the three months ended December 31, 2005. These included $284,000 of period costs as

explained in the *Overview*. Also, $181,000 of fixed production overhead cost was not inventoriable during the three months ended December 31, 2006 because our natural astaxanthin production output was below normal capacity, compared to $76,000 of below normal capacity cost recorded during the three months ended December 31, 2005. Finally, production costs associated with the Company s animal nutrition market products totaling approximately $65,000 for the three months ended December 31, 2006 compared to $14,000 for the three months ended December 31, 2005, were not inventoriable because such costs would have exceeded the market value for such inventory.

As a result of the decrease in sales coupled with the increase in cost of sales, the gross profit margin as a percentage of sales decreased to 3% for the three months ended December 31, 2006 as compared to 28% for the comparable prior year quarter. Gross profit represents net sales less the cost of product sales, which includes the cost of materials, manufacturing overhead costs, direct labor costs and depreciation and amortization. Gross profit for the three months ended December 31, 2006 was $78,000. In contrast, gross profit for the comparable period of the prior fiscal year was $659,000. Gross profit was significantly reduced in the current period by the Company recording additional otherwise inventoriable costs as expenses, as noted and discussed earlier. Explaining further, the Company judged certain production cultivation costs to be above historical averages and recognizable as current-period charges resulting from unusually low production volumes in astaxanthin and, to some extent, spirulina. These costs consisted primarily of labor, chemicals and also utility costs which were incurred in response to balancing cultivation specifications to established parameters associated with producing high quality microalgae. In addition, due to the low production volumes, certain fixed production overhead costs could not be inventoried as of December 31, 2006 because production output was below normal capacity and the inventorying of such fixed costs would have exceeded the market value for such inventory. Lastly, gross margins were impacted by market pricing constraints on the Company s animal nutrition product which limited the amount of production costs to be reflected in inventory because the costs exceeded the market value for such inventory.

Operating expenses for the three months ended December 31, 2006 and 2005 were $1,241,000 or 51% of sales and $835,000, or 36% of sales respectively, resulting in an increase of $406,000, or 49%. Research and development expenses increased $37,000 over the comparable period of the prior fiscal year while sales and marketing expenses declined $20,000. General and administrative expenses increased $389,000, primarily due to expenses that were associated with the prior fiscal year s restatement and filing of the Company s Form 10-K/A, late filings of Forms 10-Q for the first and second and third quarters of fiscal year 2007, and, to a much lesser extent, other expenses associated with the Company s one for four reverse stock split on November 3, 2006. (See Note 2 to the Consolidated Financial Statements). The Company expects that total operating expenses will increase throughout the remainder of the fiscal year due to additional efforts associated with the aforementioned restatement, late filings of Forms 10-Q and costs stemming from a remediation plan which requires that policies and procedures be designed to ensure full compliance with Generally Accepted Accounting Principles (GAAP) as it applies to inventory accounting, and to: (a) ensure that the Company s disclosures are subject to adequate and rigorous review process prior to finalizing and releasing financial statements; (b) continue to update inventory accounting systems and procedures to properly accommodate specific inventoriable fixed costs in accordance with GAAP; and (c) continue to identify resources with the critical skills necessary to ensure full compliance with GAAP. Approximately $427,000 of related audit, legal, outside consulting costs, remediation plan costs, and minor costs related to the Company s one for four reverse stock split, are included in general and administrative expenses for the current period, and these expenses were partially offset by a cumulative net reduction in several minor General and Administrative expense categories.

Net other expense for the third quarter of fiscal 2007 was $27,000, a decrease from $35,000 for the same period a year ago, with the difference primarily due to realized transaction losses with our Japanese subsidiary.

For the third quarter of fiscal 2007, an income tax benefit of $3,000 was recorded, compared to an income tax benefit of $1,000 reported for the comparable period of the prior fiscal year. The benefits arise primarily from state tax credits related to investment in property and equipment. The Company does not expect any expense to be recorded for United States income taxes in the current fiscal year as a result of available net operating loss carry forwards.

The result of the foregoing was a net loss of $1,187,000, or ($0.23) per diluted share, for the three months ended December 31, 2006, in comparison to net loss of $210,000, or ($0.04) per diluted share, for the comparable prior year quarter. The net loss occurred because of lower net sales and lower gross profit in conjunction with higher operating expenses for the current quarter.

Nine Months Ended December 31, 2006 Compared to Nine Months Ended December 31, 2005

Net sales for the nine months ended December 31, 2006 were $7,353,000, a decrease of 7% from sales of $7,879,000 reported for the comparable period a year ago. The reduction in sales over the nine month period was the largely the result of decreased sales of bulk natural astaxanthin, including NatuRose, units sold coupled with decreased Spirulina and astaxanthin bulk prices. Although spirulina bulk units sold increased and there were increases in packaged astaxanthin and spirulina unit sales and prices, these increases were offset by the decreases just discussed. Price decreases for bulk astaxanthin product were due to volume discounts and competitive pricing decisions. We expect price competition to continue for certain astaxanthin bulk products. The impact of volume discounts and competitive

pricing depends on order levels and timing, both of which we have historically been unable to predict with any degree of certainty. For the nine month period, the decrease in Spirulina sales resulted primarily from a net increase in units sold offset by a decrease in average bulk selling prices due to discounts on large volume orders.

International sales represented 46% of net sales for the nine months ended December 31, 2006 compared to 52% for the same period a year ago due to lower sales in Japan, the Asia Pacific region, and Europe. For the nine months ended December 31, 2006 and 2005, our European distributor, Spirulina International, accounted for 9% and 10% of total sales, respectively.

For the nine months ended December 31, 2006 cost of sales increased by $767,000 or 14% above the comparable prior year period. Also, for the nine months ended December 31, 2006, variable production costs increased 10% primarily in labor and chemicals. Labor costs were impacted by wage increases during the first quarter of fiscal 2007 in response to a competitive labor market (primarily from the construction industry) in Hawaii. Chemical costs increased as a result of increased consumption of nutrients and other efforts, some of which were deemed to be period costs due to abnormal usage which, particularly in the third quarter, were not effective in correcting an imbalance in the cultivation process. The foregoing cost increases, coupled with a 16% overall decrease in units produced, contributed to the Company recording additional otherwise inventoriable costs as expenses in the current period. Such costs totaled approximately $1,276,000 in nine months ended December 31, 2006 compared to $471,000 for the nine months ended December 31, 2006. These included $434,000 of period costs due primarily to the imbalance discussed above. Also, $275,000 of fixed production overhead cost was not inventoriable during the nine months ended December 31, 2006 because our natural astaxanthin production output was below normal capacity, compared to $203,000 of below normal capacity cost. being recorded during the nine months ended December 31, 2005. Finally, production costs associated with the Company s animal nutrition market products totaling approximately $309,000 for the nine months ended December 31, 2006 compared to $14,000 for the nine months ended December 31, 2005, were not inventoriable because such costs would have exceeded the market value for such inventory.

Our gross profit margin as a percentage of sales decreased to 13% for the nine months ended December, 31, 2006 from 29% for the same period a year ago. Gross margins were significantly impacted in keeping with the forgoing cost of sales discussion. With respect to the production imbalance previously discussed, which , for the current period, has become the primary reason for the Company s gross margin decrease, it is again important to note that producing the highest quality microalgae is a complex biological process which requires the tenuous balancing of numerous factors including microalgal strain variations, temperature, acidity, nutrient and other environmental considerations, some of which is not in the Company s control. As a result, especially for natural astaxanthin cultivation, it is difficult and time consuming to adjust, improve or correct the production process when quality levels fall below specifications. Until this imbalance, which primarily impacts astaxanthin, is corrected we expect production volumes to remain low and we expect our gross profit margins to remain lower than those experienced in prior comparable periods.

Operating expenses for the nine months ended December 31, 2006 were $2,969,000, an increase of $487,000 or 20% from the comparable prior year period. The increase in spending reflects higher general and administrative expense. During the current nine-month period, the Company has recorded expenses of $480,000 associated with completing the restatement of the Company s 2006 annual report on Form 10-K/A, and due to late fiscal year Form 10-Q filings, and other associated matters. Sales and marketing expenses for the nine months slightly decreased while research and development expenses slightly increased While it is our goal to contain discretionary operating spending in our research and development, sales and marketing, and general and administrative activities, it may become necessary for the company to selectively increase spending in some or all of these areas to remain competitive and to meet and, in certain areas exceed, increasing regulatory requirements. In particular, it will be necessary for the Company to incur additional general and administrative expenses due to efforts associated with the aforementioned restatement, late filings of Forms 10-Q and costs stemming from a remediation plan which requires that policies and procedures be designed to ensure full compliance with Generally Accepted Accounting Principles (GAAP) as it applies to inventory accounting, and to: (a) ensure that the Company s disclosures are subject to adequate and rigorous review process prior to finalizing and releasing financial statements; (b) continue to update inventory accounting systems and procedures to properly accommodate specific inventoriable fixed costs in accordance with GAAP; and (c) continue to identify resources with the critical skills necessary to ensure full compliance with GAAP.

Net other expense of $99,000 for the nine months ended December 31, 2006 was comparable to the same period of the prior fiscal year at $110,000, with the decrease due primarily to realized transaction losses with our Japanese subsidiary.

For the nine months ended December 31, 2006, an income tax benefit of $9,000 was recorded compared to an income tax provision of $2,000 for the comparable prior year period. The Company does not expect any United States income taxes for the current fiscal year as a result of available net operating loss carry-forwards. For income taxes, the Company records a valuation allowance to reduce its deferred tax assets to the amount that it believes is more likely than not to be realized. Judgment is required in assessing the need for the valuation allowance. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. In assessing the realizability of deferred tax assets,

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management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income and tax planning strategies in making this assessment. Based upon the level of historical taxable income and projections for future taxable income over the periods in which net deferred tax assets are deductible, management does not believe it is more likely than not the Company will realize a portion of its gross deferred tax assets, and has thus established a valuation allowance to reflect its estimated realizability. The amount of the deferred tax assets considered realizable, however, could change in the near term if estimates of future taxable income during the carryforward period change.

The Company recorded net loss of $2,106,000 or ($0.40) per diluted share for the nine month period ended December 31, 2006. For the same period a year ago the Company reported net loss of $348,000 or ($0.07) per diluted share. The net loss in the current period is primarily attributable to decreased sales in conjunction with an increase in cost of sales and higher operating expenses as compared to the same period a year ago.

Variability of Results

The Company has experienced significant quarterly fluctuations in operating results and anticipates that these fluctuations may continue in future periods. As described in previous paragraphs, operating results have fluctuated as a result of changes in sales levels to our customers, competition (both pricing, new products and other market trends) and production difficulties including increased production costs. The Company has also during its history experienced production difficulties as a result of inclement weather, changes in the mix between sales of bulk and packaged consumer products 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 the Company s control such as foreign exchange fluctuations, changes in government regulations and economic changes in the regions it operates in and sells to. 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 meaningfully adjust spending in areas such as depreciation, or the inability to adjust spending quickly enough, as in personnel and administrative costs, to compensate for a sales shortfall. 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.

Liquidity and Capital Resources

The Company s primary capital requirements are equipment and other leasehold improvement purchases, debt service obligation, and working capital requirements associated with the Company s ongoing operations.

Working capital at December 31, 2006 decreased by $1,592,000 to $4,055,000 from $5,647,000 at March 31, 2006 primarily due to significant reductions in cash and equivalents of $529,000, receivables of $690,000, and inventory of $259,000, offset partially by an increase in prepaid expenses and other current assets of $120,000.

At December 31, 2006, cash, cash equivalents and short-term investments was $2,006,000, a decrease from $2,535,000 at the beginning of the fiscal year. Net cash of $18,000 was used by operations for the nine months ended December 31, 2006 compared with $408,000 of net cash provided by operations for the comparable prior year period. The net cash used by operations during the nine months ended December 31, 2006 resulted primarily from a $1,758,000 increase in net loss in the current year compared to a net losses of $348,000 for the same period a year ago reduced by non-cash transactions. Large factors in minimizing the cash used in operations for the current period were a $686,000 reduction of accounts receivable, a $259,000 inventory decrease, and an increase of $153,000 in accounts payable.

The Company believes that its current cash position in conjunction with the expectation of future cash provided by operations will be sufficient to meet its working capital and capital expenditure requirements for at least the next 12 months. However, operating costs and the costs of restatement are placing and will continue to place an additional burden on the Company s liquidity. Once the previously discussed production imbalance is corrected the Company expects that its future production levels will be in line with future sales demand and that this will continue to allow the Company to minimize its investment in inventory held for sale. The Company continues to consider sources of capital to strengthen its financial position and liquidity should its liquidity position worsen significantly. There can be no assurance that such financing alternatives or other sources of capital will be available under favorable terms, if at all.

Cash used in investing activities (for capital expenditures) for the current nine month period was $246,000, an increase from $203,000 in the comparable prior year period.

Cash used in financing activities amounted to $265,000 and $259,000 for the nine months ended December 31, 2006 and 2005, respectively.

The Company s contractual obligations and commitments (consisting of a term loan and operating leases) are disclosed in the Company s 2006 Annual Report on Form 10-K/A in the following sections: Item 7 Management s Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources, and Item 8 Financial Statements and Supplementary Data Notes 5 and 6 of Notes to Consolidated Financial Statements. There were no significant changes in contractual obligations and commitments from March 31, 2006 to December 31, 2006.

Critical Accounting Policies

Our unaudited financial statements and accompanying notes are prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information pursuant to Regulation S-X. The Company s discussion and analysis of its financial condition and results of operations are based upon the Company s consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of financial statements in conformity with those accounting principles requires management to make judgments and estimates that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates. The Company regularly re-evaluates its judgments and estimates which are based upon historical experience and on various other assumptions that are believed to be reasonable under the circumstances. The Company believes that of its significant accounting policies, policies that may involve a higher degree of judgment and complexity are inventory valuations, valuation of equipment and leasehold improvements and long-lived assets, and income taxes. These critical accounting policies are stated in the notes to consolidated financial statements in the Company s previously filed report on Form 10-K/A, for the fiscal year ended March 31, 2006. This discussion and analysis should be read in conjunction with such notes and our consolidated financial statements and related notes included elsewhere in this report.

Outlook

This outlook section contains a number of forward-looking statements, all of which are based on current expectations. Actual results may differ materially. Also, see the first paragraph of Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operation s

Cyanotech Corporation s strategic direction is to position itself 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. For fiscal 2007 we are focused on the business-to-business wholesale market for the products and compounds that we produce. Our current product offerings include Naturally Cultivated Spirulina Pacifica® in powder, flake and tablet form, NatuRose® natural astaxanthin powder for the animal nutrition market, BioAstin® natural astaxanthin antioxidant in lipid extract, softgel caplet and micro-encapsulated beadlet form for the human nutrition and cosmetic industries and Phycobiliproteins for use in medical diagnostics. Information about our Company and our products can be viewed at www.cyanotech.com, www.nutrex-hawaii.com or www.phycobiliprotein.com. Consumer products can also be purchased online at www.nutrex-hawaii.com .

Currently, the Company s natural astaxanthin production levels are below previous periods due to an imbalance in certain cultivation specifications compared to established parameters associated with producing high quality microalgae. Some natural astaxanthin orders for both the animal nutrition and the human market were backlogged as of December 31, 2006 due to the lower production volumes in the current year. However, customers are not obligated to purchased backlogged product and may seek alternatives or forgo purchases. While the Company is actively working to address the imbalance situation, it might take many weeks or months to restore production to normal capacity volumes. Natural astaxanthin cultivation is a complex biological process which requires the tenuous balancing of numerous factors including microalgal strain variations, temperature, acidity, nutrient and other environmental considerations, some of which is not in the Company s control. As a result, especially for natural astaxanthin cultivation, it is difficult and time consuming to adjust, improve or correct the production process when quality levels fall below specifications, and, while the Company possesses the scientific knowledge and resources to correct its production processes, there are too many variables involved for the Company to make reliable projections concerning such efforts.

In addition, for the current fiscal year, the Company has been unable to inventory the full cost of producing its natural astaxanthin product for the animal nutrition market due to lower of cost or market constraints. As a result, we are shifting our natural astaxanthin

production toward higher valued products such as BioAstin for human consumption until and if such time that profitable animal nutrition markets or other astaxanthin markets can be identified that can generate reasonable profitability for the Company.

The Company is exploring options to expand consumer brand awareness and knowledge of its product lines, with particular focus of BioAstin, the Company s human natural astaxanthin product line, for which it believes full market penetration has not yet been realized. To accomplish these objectives the Company, among other initiatives, has, as of the date of filing this report, based a knowledgeable sales employee on the US mainland to increase the Company s outreach to both the US and European markets.

Gross profit margin percentages in fiscal 2007, and early next fiscal year, are expected to remain lower in comparison to previous periods. This is primarily due to the aforementioned production imbalance. In addition, the Company has experienced cost increases as certain variable operating costs for utilities, production labor, and pond nutrients have increased in comparison to previous periods. The Company s utility costs are impacted by the price of oil, which is used to generate electricity for processing and for water pumping. In the face of a robust local construction economy, the Company found it necessary to increase production wages in order to retain key employees and attract qualified personnel. With competition increasing and higher production costs, pressure is placed on achieving a reasonable profit margin. When market value, including a reasonable profit margin, cannot be achieved, production costs exceeding the product s market value cannot be inventoried and is reflected immediately in cost of sales. Additionally, with the adoption of SFAS 151, the Company recognizes costs associated with abnormal amounts of idle facility expense, freight, handling costs and wasted materials (such as spoilage) as current-period charges in cost of sales. When production costs exceed historical averages, the Company evaluates whether such costs are current-period charges or can be inventoried. In addition, the allocation of such fixed production overheads (such as depreciation and general insurance) to inventories is determined based on normal production capacity. When the Company s production volumes are below normal capacity limits, certain fixed production overhead costs cannot be inventoried and are recorded immediately in cost of sales. Currently, the Company s natural astaxanthin production levels (and to a much lesser extent Spirulina production levels during the period ended December 31, 2006) are below previous periods and normal production levels due to an imbalance in certain cultivation specifications in comparison to parameters associated with producing high quality microalgae. Again, producing the highest quality microalgae is a complex biological process which requires balancing numerous factors including microalgal strain variations, temperature, acidity, nutrient and other environmental considerations, some of which are not within the Company s control. It is difficult and time consuming to adjust, improve or correct the production process when quality levels fall below specifications. As a result, we experienced a production shortfall in our natural astaxanthin products during the three and nine months ended December 31, 2006. These shortfalls likely resulted in decreased sales since customers are able to secure alternative products or are able to forgo purchases. Until the Company is able to prudently increase its level of natural astaxanthin production, the Company believes margins will continue to be negatively impacted by all of the foregoing cost elements, and margins are expected to remain lower than those reported for comparable previous periods.

The Company anticipates that future total operating expenses will increase due to the costs of the restatement and the remediation of errors identified by the restatement, including the need to improve the Company s internal controls. *Please refer to Part II, Item 4 (a) in this report.* In addition, increased costs are expected as a result of management s recommendation and the Company s Audit Committee and Board of Directors approval and adoption of a remediation plan which includes that policies and procedures will be designed to ensure full compliance with GAAP, particularly as it applies to inventory accounting, and will address key financial reporting risk elements, including the following: (a) ensuring that its disclosures are subject to an adequate review process prior to finalizing and releasing financial statements; (b) continuing to update its inventory accounting systems and procedures to properly accommodate specific inventoriable fixed costs in accordance with GAAP; and (c) continuing to identify resources with the critical skills necessary to ensure full compliance with GAAP. Since the process related to error identification and the subsequent restatement began after June 30, 2006, much of the related audit, legal, outside consulting costs, and remediation plan costs are included in and are applicable to this Form 10-Q. For the quarter ended December 31, 2006, $428,000 of such costs are reflected in general and administrative expenses, and for the nine months ended December 31, 2007, $480,000 of such costs are reflected.

To effectively manage its cash resources the Company will continue to balance production in light of sales demand, minimizing the cost associated with build-ups in inventory. Additionally, the Company has experienced cash outflows for investing and financing activities, primarily in meeting debt repayment obligations and may need to utilize cash to meet working capital needs if prolonged net losses are incurred in future periods. A prolonged downturn in sales could impair the Company s ability to generate sufficient cash for operations and minimize the Company s ability to attract additional capital investments which may be necessary in order to expand into new markets or increase product offerings.

The Company s 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; shortage of manufacturing capacity; and other factors beyond our control. Risk factors are discussed in detail in Item 1A, included in this report.

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Cyanotech believes that it has the product offerings, facilities, personnel, and competitive and financial resources for improved results, but future revenues, costs, margins and profits are all influenced by a number of factors, as discussed above, all of which are inherently difficult to forecast.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

We have not entered 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 a term loan agreement which adjusts quarterly based on the prime rate plus 1%. As such we are exposed to interest rate risk whereby a 1% increase or decrease in the prime rate would lead to an increase or decrease of approximately $15,000 in interest expense for the year ending March 31, 2007 (based on March 31, 2006 amounts outstanding).

The Company may enter into additional foreign countries in the future which may involve similar economic and political risks as well as challenges that are different from those currently encountered by the Company.

Item 4. Controls and Procedures

(a) Disclosure Controls and Procedures

This Form 10-Q should be read in conjunction with Item 9A Controls and Procedures of the Company s Form 10-K/A for the fiscal year ended March 31, 2006 filed February 14, 2007, which is incorporated herein by reference.

There were changes in Controls and Procedures during the current quarter. As disclosed in the Form 10-Q report for the second quarter of fiscal year 2007, beginning in that quarter the Company identified errors in the application of certain accounting practices and procedures. As a result, during the second and third quarters of fiscal year 2007 the Company began changing and is continuing the process of improving its control policies, procedures, and systems. This process was and is directly related to the Company s February 14, 2007 filing of Form 10-K/A, correction of the error in its inventory accounting, and also a remediation plan adopted by the Board of Directors in November 2006 as discussed in Form 10-K/A, especially Note 13 to the Consolidated Financial Statements therein.

Because the aforementioned error was discovered by the Company on August 7, 2006, it is clear that as of June 30, 2006 the Company did not maintain effective controls over accounting for inventory. Specifically, errors resulted because the Company did not have effective policies and procedures and adequately trained and qualified accounting department staff to ensure that inventory included all inventoriable fixed cost components such as depreciation, portions of general insurance costs, and portions of direct labor burden costs in accordance with GAAP. As a result of this weakness, which was later determined by the Company to be material, the Company restated its consolidated financial statements as of and for the fiscal years ended March 31, 2006, 2005, and quarterly periods within fiscal years 2006, 2005, and 2004 and has restated selected financial data for the years ended March 31, 2003 and 2002 to adjust its inventory balances, cost of goods sold, and related amounts of income and loss. The restatement is reflected in the Company s Form 10-K/A filed February 14, 2007, and is reflected in restated prior period comparable information contained in this Form 10-Q.

The process of investigating and rectifying the aforementioned errors has resulted in the Company enhancing and continuing to enhance its accounting policies and procedures to assure that inventoriable fixed cost components such as depreciation, portions of general insurance costs, and portions of direct labor burden costs are reflected in the Company s financial statements in accordance with GAAP. Because of the nature of and circumstances surrounding the errors, the Company s management, Board of Directors, and Audit Committee of the Board of Directors concluded that the errors were not the result of illegal acts.

Specific changes in the Company s internal control over financial reporting during the third quarter of fiscal year 2007 included:

Additional improvements in inventory accounting procedures and systems.

Heightening enterprise level review and evaluation of inventory accounting policies, procedures, and systems.

Engaging additional professional accounting resources on a consulting basis to assist with error evaluation and correction, and taking specific steps to find and hire additional professional accounting employees to bolster both financial reporting and inventory accounting in-house capabilities. As of this filing, we are still seeking additional suitable professional accounting employees.

Incorporated into the results reported in this Form 10-Q are the above discussed restatement and inventory accounting error corrections which ensure that inventory as reported herein includes all inventoriable fixed cost components such as depreciation, portions of general insurance costs, and portions of direct labor burden costs in accordance with GAAP.

PART II. OTHER INFORMATION6

Item 1. Legal Proceedings
None

Item 1A. Risk Factors

You should carefully consider the risks described below which we believe are significant but not the only ones we face. Any of the following risks could have a material adverse effect on our business, financial condition and operating results. You should also refer to the other information contained in this report, including our financial statements and the related notes.

A Significant or Prolonged Economic Downturn Could Have a Material Adverse Effect on Our Results of Operations

Our results of operations are affected by the business activity of our customers who in turn are affected by the level of economic activity in the industries and markets that they serve. A decline in the level of business activity of our clients could have a material adverse effect on our revenues and profit margin.

Our Quarterly Operating Results May Vary From Quarter to Quarter, Which May Result in Increased Volatility of Our Share Price

We have experienced, and may in the future continue to experience, fluctuations in our quarterly operating results. These fluctuations could reduce the market price of our Common Stock. Factors that may cause our quarterly operating results to vary include, but are not limited to:

- the business decisions of our customers regarding orders for our products;
- increased energy costs;
- increased raw material costs;
- production difficulties, especially CO2 interruption, which could shut down production;
- weather-related cultivation difficulties;
- contamination of our cultivation and production facilities;
- the effect of weather on customer demand patterns;
- the introduction of new products by us or our competitors;
- changes in our pricing policies or those of our competitors;
- seasonal trends in our customers buying patterns
- changes in government regulation, both domestic and foreign;
- fluctuation in foreign currency exchange rates;
- global economic and political conditions and related risks, including acts of terrorism; and
- customers using alternative, possibly synthetic, products;

- an inability to produce or deliver orders;
- product quality issues which may restrict production or require product recall;
- other factors beyond our control.

A significant portion of our expense levels are relatively fixed and the timing of increases in expense levels is based in large part on our forecasts of future sales. If net sales are below expectations in any given period, the adverse impact on results of operations may be magnified by our inability to adjust expenses quickly enough to compensate for the sales shortfall.

Our Global Operations Expose Us to Complex Management, Foreign Currency, Legal, Tax and Economic Risks, Which We May Not Be Able to Address Adequately

We conduct business in a number of countries around the world. For the quarter ended December 31, 2006, approximately 44% of our net sales were from sales to foreign customers. As a result, we are subject to a number of risks that include, but are not limited to:

- the burden of complying with a wide variety of national and local laws;
- potentially longer payment cycles for foreign sales;
- multiple and possibly overlapping and conflicting tax laws;
- coordinating geographically separated locations;
- restrictions (government and otherwise) on the movement of cash;
- the absence in some jurisdictions of effective laws protecting our intellectual property rights;
- changes in government regulations, both domestic and foreign;
- global economic and political conditions and related risks, including acts of terrorism; and
- fluctuations in foreign currency exchange rates.

Competition in Our Industry is Intense

The nutritional products market is highly competitive. In includes international, national, regional and local producers and distributors, many of whom have greater resources than Cyanotech and offer a greater variety of products. Increased competition in our industry could result in price reductions, reduced gross profit margin or loss of market share, any of which could have a material effect on our business, results of operations and financial condition.

Our Revenues Could Be Adversely Affected By the Loss of a Significant Customer or the Failure to Collect a Large Accounts Receivable

We have in the past derived, and may continue in the future to derive, a significant portion of our revenues from a relatively limited number of major customers. From quarter to quarter, revenues from one or more individual customers may exceed 10% of our revenues for the quarter. During the year ended March 31, 2006, sales to one customer, a European distributor of natural products, were approximately 12% of net sales. If sales to this customer or other such major customer decrease significantly, this may materially affect our results of operations. In addition, if we fail to collect large accounts receivable from such major customers, we could be subject to significant financial exposure. For the nine months ending December 31, 2006, sales to this European distributor represented less than 10% of total sales.

If We Are Unable to Protect Our Intellectual Property Rights or if We Infringe Upon the Intellectual Property Rights of Others Our Business May Be Harmed

The Company has received five United States patents: two on aspects of our production methods and three for use of our BioAstin® products. Although we regard our proprietary technology, trade secrets, trademarks and similar intellectual property as important, we rely on a combination of trade secret, contract, patent, copyright and trademark law to establish and protect our rights in our products and technology. There can be no assurance that we will be able to protect our technology adequately or that competitors will not be able to develop similar technology independently. In addition, the laws of certain foreign countries may not protect the Company s intellectual property rights to the same extent as the laws of the United States. Litigation in the United States or abroad may be necessary to enforce our patent or other intellectual property rights, to protect our trade secrets, to determine the validity and scope of the proprietary rights of others or to defend against claims of infringement. Such litigation, even if successful, could result in substantial costs and diversion of resources and could have a material adverse effect on our business, results of operations and financial condition. Additionally, if any such claims are asserted against us, we may seek to obtain a license under the third party s intellectual property rights. There can be no assurance, however, that a license would be available on terms acceptable or favorable to us, if at all.

We May Need to Raise Additional Capital in the Future Which May Not Be Available

At December 31, 2006, the Company s working capital was $4,055,000. Cash equivalents and short-term investments at December 31, 2006 totaled $2,066,000. Our cash requirements will depend on numerous factors, including: demand for products; normal requirements to maintain and upgrade facilities and equipment; whether opportunities emerge in either new markets or in research and development activities; or, in the event we need to expand or contract our production or distribution infrastructure. We believe our current cash, cash equivalents, short-term investments and expected cash provided from operations will be sufficient to meet our capital requirements for at least the next 12 months. If we need to raise additional funds, we may not be able to secure funding on acceptable terms, if at all. If we raise additional funds through the issuance of equity or convertible debt securities, the percentage ownership of our then current stockholders may be reduced. If we raise additional funds through the issuance of convertible debt securities, or through additional debt or similar instruments, such securities, debt, or similar instruments could have rights senior to those of our common stockholders and such instruments could contain provisions restricting our operations. If adequate funds are not available to satisfy either short-term or long-term capital requirements, we may be required to limit operations with adverse results.

Our Insurance Liability Coverage is Limited

In the ordinary course of business, the Company purchases insurance coverages (e.g., property and liability coverages) to protect itself against loss of or damage to its properties and claims made by third parties and employees for property damage or personal injuries. However, the protection provided by such insurance is limited in significant respects and, in some instances, the Company has no coverage and certain of the Company s insurance has substantial deductibles or has limits on the maximum amounts that may be recovered. For example, if a hurricane or other uninsured catastrophic natural disaster should occur, the Company may not be able to recover all facility restoration costs and revenues lost from business interruption. In addition, the Company maintains product liability insurance in limited amounts for all of its products involving human consumption; however, broader product liability coverage is prohibitively expensive. Insurers have also introduced new exclusions or limitations of coverage for claims related to certain perils including, but not limited to, mold and terrorism. If a series of losses occurred, such as from a series of lawsuits in the ordinary course of business each of which were subject to the deductible amount, or if the maximum limit of the available insurance were substantially exceeded, the Company could incur losses in amounts that would have a material adverse effect on its result of operations and financial condition.

Our Ability to Develop and Market New Products or Modify Existing Products and Production Methods May be Adversely Affected If we Lose the Services of or Cannot Replace Certain Employees Knowledgeable in Advanced Scientific and Other Fields

The Company s products are derived from and depend on proprietary and non-proprietary processes and methods founded on advanced scientific knowledge, skills, and expertise. If the services of employees knowledgeable in these fields are lost and cannot be replaced in a reasonable time frame at reasonable costs, the Company s ability to develop and market new products or modify existing products and production methods would be adversely impacted. At the same time, regulatory compliance surrounding the Company s products and financial matters generally requires minimum levels of knowledge and expertise related to production, quality assurance, and financial control. If the Company loses the services or cannot reasonably replace employees who have the necessary knowledge and expertise the Company s ability to remain in regulatory compliance could be adversely affected.

As a Result of Restating the Company s Form 10-K/A and the Late Filing of Form 10-Qs, Additional General and Administrative Expenditures Will Be Required in Future Periods

During the current fiscal year the Company expects to expend significant amounts for independent registered public accounting, legal, outside consulting, and regulatory expenses to address: (a) the previously discussed 10-K/A restatement process, (b) previously disclosed matters dealing with resulting potential delisting from the Nasdaq Capital Market, (c) policy, procedure, and initial systems modifications required by and attendant to correcting the historical error which lead to the restatement process, and (d) additional costs related to late filing of the Company s Forms 10-Q for the first two quarters of fiscal year 2007. Also, to accomplish the remediation plan set forth in the 10-K/A under Item 9A Controls and Procedures therein. As of the filing date of this Form 10-Q the Company has expended approximately $500,000 related to such efforts, and will have to expend additional amounts which cannot now be reliably estimated.

The Company Will Incur Additional Sums In the Future in Order to Comply with Securities and Exchange and Public Company Accounting Oversight Requirements Resulting from the Sarbanes-Oxley Act

As of March 31, 2008, the Company is required to have additional policies, procedures, systems and related documentation in compliance with Securities and Exchange Commission and Public Company Accounting Oversight Board requirements. There is currently no means of reliably estimating the costs of such additional compliance.

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Potential Delisting from Nasdaq Capital Market Trading

On December 1, 2005 the Company received notice from Nasdaq that the bid price of the Company s stock closed below the minimum $1.00 per share requirement of Nasdaq Marketplace Rule 4310(c)(4). The Company, however, was provided until May 30, 2006, to regain compliance with such rule, and was granted by letter dated May 31, 2006 another 180 days to regain compliance with such rule. By letter dated August 23, 2006, the Company was notified by Nasdaq of its failure to comply with Nasdaq Marketplace Rule 4310(c)(14) for not filing its Form 10 Q for the quarter ended June 30, 2006 and we were notified that the Company s common stock would be suspended from trading on September 1, 2006. The Company appealed this decision and the common stock continued to be listed.

On November 3, 2006, the Company implemented a one for four reverse stock split of its common stock as a result of which Nasdaq issued a letter, dated November 20, 2006, indicating the closing bid price of our common stock was in compliance with Marketplace Rule 4310(c)(4). This non-compliance matter is now closed.

The Nasdaq Listing Qualifications Panel issued its decision on the appeal on December 18, 2006 holding that the Company is granted an extension until February 20, 2007 to file its Form 10-Q reports. See the Company s Form 8-K dated December 18, 2006.

Subsequently, on February 14, 2007 the Company filed Form 10-K/A amending and restating its Form 10-K for the year ended March 31, 2006. Also, on February 20, 2007 the Company filed Forms 10-Q for the quarters ended June 30 and September 30, 2006, in compliance with the December 18, 2006 extension discussed above. Cyanotech Corporation received notice on February 21, 2007 from The NASDAQ Stock Market that the Company is not in Compliance with Nasdaq Marketplace Rule 4310(c)(14) for failure to file its Form 10-Q for the period ended December 31, 2006 and that such failure is basis for delisting the Company s Common Stock from The Nasdaq Stock Market. The Company was granted until February 28, 2007 to present its views to the Nasdaq Listing Qualifications Panel with respect to the failure to file such Form 10-Q. In its response the Company indicated that it expected to file the Form 10-Q report on or before March 14, 2007 and requested continued listing. On February 28, 2007, based on its supplemental response and request for continued listing submitted by the Company to Nasdaq, the Company received notice that the Nasdaq Listing Qualifications Panel has determined to grant the Company s request for continued listing subject primarily to the Company s filing on or before March 14, 2007 its Form 10-Q for the period ended December 31, 2006. In addition, the Company must be able to demonstrate compliance with all requirements for continued listing. As of the time of filing this report, the Company believes it meets all of the requirements for continued listing stated in the Listing Qualifications Panel determination of February 28, 2007. However, if the Company is incorrect in its belief, and the Company s common stock is delisted, our stockholders could be materially and adversely affected by having less active and efficient market available for the trading of their stock.

Item 4. Submission of Matters to a Vote of Security Holders

None -

Item 6. Exhibits

a) The following exhibits are furnished with this report:

31.1	Certification by the Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Exchange Act
31.2	Certification by the Chief Financial Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Exchange Act
32.1	Certification by the Chief Executive Officer pursuant to 18 U. S. C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification by the Chief Financial Officer pursuant to 18 U. S. C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

b) Reports on Form 8-K

A report on Form 8-K dated October 16, 2006 included Item 3.03, Material Modification of Rights of Securities Holders.

A report on Form 8-K dated November 14, 2006 included Item 3.01, Notice of Delisting or Failure to Satisfy a Continued Listing Rule or Standard; Transfer of Listing.

A report on Form 8-K dated November 14, 2006 included Item 3.03, Material Modification to Rights of Securities Holders.

A report on Form 8-K dated November 14, 2006 included Item 8.01, Other Events.

A report on Form 8-K dated November 28, 2006 included Item 2.02, Results of Operations and Financial Condition.

A report on Form 8-K dated November 28, 2006 included Item 4.02, Results of Operations and Financial Condition.

A report on Form 8-K dated December 18, 2006 included Item 8.01, Other Events:

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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)

March 13, 2007 (Date)	By:	/s/ Gerald R. Cysewski Gerald R. Cysewski Chairman of the Board, President and President and Chief Executive Officer
March 13, 2007 (Date)	By:	/s/ William R. Maris William R. Maris Vice President Finance & Administration, Chief Financial Officer (Principal Financial and Accounting Officer)

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