

AeroVironment Inc
Form 10-Q
December 09, 2015
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended October 31, 2015

OR

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

For the transition period from to

Commission File Number: 001-33261

AEROVIRONMENT, INC.

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of incorporation or organization)

95-2705790

(I.R.S. Employer Identification No.)

**900 Innovators Way
Simi Valley, California**

(Address of principal executive offices)

93065

(Zip Code)

(626) 357-9983

(Registrant's telephone number, including area code)

N/A

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

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

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

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

Large accelerated filer

Accelerated filer

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

Smaller reporting company

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

As of November 27, 2015, the number of shares outstanding of the registrant's common stock, \$0.0001 par value, was 23,334,628.

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Table of Contents**PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****AeroVironment, Inc.****Consolidated Balance Sheets****(In thousands except share and per share data)**

	October 31, 2015 (Unaudited)	April 30, 2015
Assets		
Current assets:		
Cash and cash equivalents	\$ 128,032	\$ 143,410
Short-term investments	77,967	85,381
Accounts receivable, net of allowance for doubtful accounts of \$212 at October 31, 2015 and \$606 at April 30, 2015	42,746	33,607
Unbilled receivables and retentions	11,798	17,356
Inventories, net	48,336	39,414
Income tax receivable	2,836	
Deferred income taxes	5,050	5,265
Prepaid expenses and other current assets	4,555	4,599
Total current assets	321,320	329,032
Long-term investments	37,715	46,769
Property and equipment, net	13,579	13,499
Deferred income taxes	6,725	7,426
Other assets	690	741
Total assets	\$ 380,029	\$ 397,467
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	\$ 11,590	\$ 19,243
Wages and related accruals	10,503	13,395
Income taxes payable		692
Customer advances	3,835	4,235
Other current liabilities	5,669	9,170
Total current liabilities	31,597	46,735
Deferred rent	1,266	1,381
Liability for uncertain tax positions	439	439
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, \$0.0001 par value:		
Authorized shares 10,000,000; none issued or outstanding		
Common stock, \$0.0001 par value:		
Authorized shares 100,000,000		
Issued and outstanding shares 23,318,688 at October 31, 2015 and 23,314,640 at April 30, 2015	2	2
Additional paid-in capital	151,269	148,293

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Accumulated other comprehensive loss	(201)	(1,358)
Retained earnings	195,657	201,975
Total stockholders' equity	346,727	348,912
Total liabilities and stockholders' equity	\$ 380,029	\$ 397,467

See accompanying notes to consolidated financial statements (unaudited).

Table of Contents**AeroVironment, Inc.****Consolidated Statements of Operations (Unaudited)****(In thousands except share and per share data)**

	Three Months Ended		Six Months Ended	
	October 31, 2015	November 1, 2014	October 31, 2015	November 1, 2014
Revenue:				
Product sales	\$ 49,492	\$ 42,874	\$ 76,131	\$ 85,685
Contract services	15,239	9,790	35,650	18,845
	64,731	52,664	111,781	104,530
Cost of sales:				
Product sales	24,802	27,779	41,567	58,576
Contract services	8,396	7,014	22,658	14,029
	33,198	34,793	64,225	72,605
Gross margin:				
Product sales	24,690	15,095	34,564	27,109
Contract services	6,843	2,776	12,992	4,816
	31,533	17,871	47,556	31,925
Selling, general and administrative	14,733	13,470	29,989	26,873
Research and development	9,897	8,531	19,728	15,655
Income (loss) from operations	6,903	(4,130)	(2,161)	(10,603)
Other income (expense):				
Interest income	268	193	492	405
Other (expense) income	(192)	(583)	(2,581)	8
Income (loss) before income taxes	6,979	(4,520)	(4,250)	(10,190)
Provision (benefit) for income taxes	2,560	(1,619)	(1,688)	(3,680)
Net Income (loss)	\$ 4,419	\$ (2,901)	\$ (2,562)	\$ (6,510)
Earnings (loss) per share data:				
Basic	\$ 0.19	\$ (0.13)	\$ (0.11)	\$ (0.29)
Diluted	\$ 0.19	\$ (0.13)	\$ (0.11)	\$ (0.29)
Weighted average shares outstanding:				
Basic	22,985,956	22,878,410	22,966,513	22,840,465
Diluted	23,148,456	22,878,410	22,966,513	22,840,465

See accompanying notes to consolidated financial statements (unaudited).

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AeroVironment, Inc.

Consolidated Statements of Comprehensive Income (Loss) (Unaudited)

(In thousands)

	Three Months Ended		Six Months Ended	
	October 31, 2015	November 1, 2014	October 31, 2015	November 1, 2014
Net income (loss)	\$ 4,419	\$ (2,901)	\$ (2,562)	\$ (6,510)
Other comprehensive income (loss):				
Unrealized gain (loss) on investments, net of tax expense of \$17 and \$(429) for the three months ended October 31, 2015 and November 1, 2014, respectively; and net of tax expense of \$18 and \$(397) for the sixth months ended October 31, 2015 and November 1, 2014, respectively	25	(644)	27	(596)
Total comprehensive income (loss)	\$ 4,444	\$ (3,545)	\$ (2,535)	\$ (7,106)

See accompanying notes to consolidated financial statements (unaudited).

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AeroVironment, Inc.

Consolidated Statements of Cash Flows (Unaudited)

(In thousands)

	Six Months Ended	
	October 31, 2015	November 1, 2014
Operating activities		
Net loss	\$ (2,562)	\$ (6,510)
Adjustments to reconcile net loss to cash (used in) provided by operating activities:		
Depreciation and amortization	2,765	4,303
Impairment of available-for-sale securities	2,186	
Loss from equity method investments	122	98
Provision for doubtful accounts	(231)	(105)
Deferred income taxes	215	42
Loss (gain) on sale of equity securities	219	(347)
Stock-based compensation	2,082	1,745
Foreign currency losses	63	281
Increase in fair value of conversion feature of convertible bonds		(73)
Tax benefit from exercise of stock options	196	11
Excess tax benefit from stock-based compensation		(348)
Amortization of held-to-maturity investments	2,146	2,211
Changes in operating assets and liabilities:		
Accounts receivable	(8,908)	748
Unbilled receivables and retentions	5,558	3,826
Inventories	(8,922)	(1,105)
Income tax receivable	(2,887)	1,708
Other assets	119	27
Accounts payable	(7,653)	5,082
Other liabilities	(7,417)	764
Net cash (used in) provided by operating activities	(22,909)	12,358
Investing activities		
Acquisitions of property and equipment	(2,804)	(1,070)
Equity method investments	(186)	(186)
Purchases of held-to-maturity investments	(43,072)	(68,524)
Redemptions of held-to-maturity investments	55,847	46,727
Sales of available-for-sale investments	987	9,038
Net cash provided by (used in) investing activities	10,772	(14,015)
Financing activities		
Purchase and retirement of common stock	(3,756)	
Tax withholding payment related to net settlement of equity awards	(29)	
Excess tax benefit from exercise of stock options		348
Exercise of stock options	544	679
Net cash (used in) provided by financing activities	(3,241)	1,027
Net decrease in cash and cash equivalents	(15,378)	(630)
Cash and cash equivalents at beginning of period	143,410	126,969
Cash and cash equivalents at end of period	\$ 128,032	\$ 126,339
Supplemental disclosure:		
Unrealized change in fair value of investments recorded in other comprehensive income (loss), net of deferred taxes of \$18 and \$(397), respectively	\$ 27	\$ 596
Reclassification from share-based liability compensation to equity	\$ 228	

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See accompanying notes to consolidated financial statements (unaudited).

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AeroVironment, Inc.

Notes to Consolidated Financial Statements (Unaudited)

1. Organization and Significant Accounting Policies

Organization

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

Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (U.S. GAAP) for interim financial information and with the instructions of Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. In the opinion of management, all adjustments, consisting only of normal recurring adjustments necessary for a fair presentation with respect to the interim financial statements have been included. The results of operations for the three and six months ended October 31, 2015, are not necessarily indicative of the results for the full year ending April 30, 2016. For further information, refer to the consolidated financial statements and footnotes thereto for the year ended April 30, 2015, included in the Company's Annual Report on Form 10-K.

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

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

Reclassifications

Certain prior year amounts have been reclassified to conform to the current year presentation.

Segments

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

Investments

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

Fair Values of Financial Instruments

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

Government Contracts

Payments to the Company on government cost reimbursable contracts are based on provisional, or estimated indirect rates, which are subject to an annual audit by the Defense Contract Audit Agency (DCAA). The cost audits result in the negotiation and determination of the final indirect cost rates that the Company may use for the period(s) audited. The final rates, if different from the provisional billing rates, may create an additional receivable or liability for the Company. For example, during the course of its audits, the DCAA may question the Company's incurred project costs, and if the DCAA believes the Company has accounted for such costs in a manner inconsistent with the requirements under Federal Acquisition Regulations, the DCAA auditor may recommend to the Company's administrative contracting officer to disallow such costs. The Company can provide no assurance that the DCAA or other government audits will not result in material disallowances for incurred costs in the future.

Table of Contents**AeroVironment, Inc.****Notes to Consolidated Financial Statements (Unaudited)**

The Defense Contract Management Agency, or (DCMA), has disallowed a portion of the Company's executive compensation and other costs included in the Company's fiscal year 2006 incurred cost claim and sought interest and penalties. The Company and DCMA have resolved most of these claims. However, the Company is vigorously defending its position on the government's remaining claims for the fiscal 2006 incurred cost claim which the Company has appealed to the Armed Services Board of Contract Appeals. Based on the Company's current understanding of the facts and the amount in dispute, the Company believes that the outcome of these disputes will not have a material impact on the Company's business. Claims related to other fiscal years were settled during the three and six months ended October 31, 2015, as described in Note 9. As of October 31, 2015 and April 30, 2015, the Company had reserves for incurred cost claim audits for various fiscal years.

Earnings (Loss) Per Share

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

The reconciliation of basic to diluted shares is as follows:

	Three Months Ended		Six Months Ended	
	October 31, 2015	November 1, 2014	October 31, 2015	November 1, 2014
Denominator for basic earnings (loss) per share:				
Weighted average common shares outstanding, excluding unvested restricted stock	22,985,956	22,878,410	22,966,513	22,840,465
Dilutive effect of employee stock options and unvested restricted stock	162,500			
Denominator for diluted earnings (loss) per share	23,148,456	22,878,410	22,966,513	22,840,465

During the three months ended October 31, 2015, approximately 21,000 shares reserved for issuance upon exercise of stock options and shares of unvested restricted stock were not included in the computation of diluted earnings per share because their inclusion would have been anti-dilutive. Due to the net loss for the three months ended November 1, 2014 and six months ended October 31, 2015 and November 1, 2014, no shares reserved for issuance upon exercise of stock options or shares of unvested restricted stock were included in the computation of diluted loss per share as their inclusion would have been anti-dilutive.

Recently Issued Accounting Standards

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In July 2015, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2015-17, *Income Taxes (Topic 740) - Balance Sheet Classification of Deferred Taxes*. This update simplifies the presentation of deferred income taxes, by requiring that deferred tax liabilities and assets be classified as noncurrent in a classified statement of financial position. The current requirement that deferred tax liabilities and assets of a tax-paying component of an entity be offset and presented as a single amount is not affected by the amendments in this update. This update is effective for financial statements issued for annual periods beginning after December 15, 2016, and interim periods within those annual periods. The Company is evaluating the potential impact of adoption on its consolidated financial statements.

In May 2014, the FASB issued ASU No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*. The new standard was originally effective for reporting periods beginning after December 15, 2016 and early adoption was not permitted. In August 2015, the FASB issued ASU No. 2015-14, *Revenue from Contracts with Customers (Topic 640)-Deferral of the Effective Date*. This update approved a one year delay of the effective date to reporting periods beginning after December 15, 2017, while permitting companies to voluntarily adopt the new standard as of the original effective date. The Company is currently evaluating when to adopt the new standard and the potential impact of adoption on its consolidated financial statements.

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

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Investments consist of the following (in thousands):

	October 31, 2015	April 30, 2015
Short-term investments:		
Held-to-maturity securities:		
Municipal securities	\$ 57,308	\$ 67,173
U.S. government securities	6,014	11,536
Corporate bonds	13,902	1,314
Certificates of deposit	743	3,885
Total held-to-maturity investments	77,967	83,908
Available-for-sale securities:		
Equity securities		1,473
Total available-for-sale investments		1,473
Total short-term investments	\$ 77,967	\$ 85,381
Long-term investments:		
Held-to-maturity securities:		
Municipal securities	\$ 11,938	\$ 30,418
U.S. government securities		5,009
Corporate bonds	23,012	8,501
Total held-to-maturity investments	34,950	43,928
Available-for-sale securities:		
Auction rate securities	2,765	2,841
Total available-for-sale investments	2,765	2,841
Total long-term investments	\$ 37,715	\$ 46,769

Held-To-Maturity Securities

As of October 31, 2015 and April 30, 2015, the balance of held-to-maturity securities consisted of state and local government municipal securities, U.S. treasury securities, corporate bonds and certificates of deposit. Interest earned from these investments is recorded in interest income.

The amortized cost, gross unrealized gains, gross unrealized losses, and estimated fair value of the held-to-maturity investments as of October 31, 2015, were as follows (in thousands):

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	Amortized Cost		Gross Unrealized Gains		Gross Unrealized Losses		Fair Value
Municipal securities	\$ 69,246	\$	34	\$	(3)	\$	69,277
U.S. government securities	6,014		5				6,019
Corporate bonds	36,914		5		(56)		36,863
Certificates of deposit	743						743
Total held-to-maturity investments	\$ 112,917	\$	44	\$	(59)	\$	112,902

The amortized cost, gross unrealized gains, gross unrealized losses, and estimated fair value of the held-to-maturity investments as of April 30, 2015, were as follows (in thousands):

	Amortized Cost		Gross Unrealized Gains		Gross Unrealized Losses		Fair Value
Municipal securities	\$ 97,591	\$	8	\$	(35)	\$	97,564
U.S. government securities	16,545		12				16,557
Corporate bonds	9,815				(13)		9,802
Certificates of deposit	3,885						3,885
Total held-to-maturity investments	\$ 127,836	\$	20	\$	(48)	\$	127,808

Table of Contents**AeroVironment, Inc.****Notes to Consolidated Financial Statements (Unaudited)**

The amortized cost and fair value of the held-to-maturity securities by contractual maturity at October 31, 2015, were as follows (in thousands):

	Cost	Fair Value
Due within one year	\$ 77,967	\$ 77,976
Due after one year through three years	34,950	34,926
Total	\$ 112,917	\$ 112,902

Available-For-Sale Securities**Auction Rate Securities**

As of October 31, 2015 and April 30, 2015, the entire balance of available-for-sale, auction rate securities, consisted of two investment grade auction rate municipal bonds, with maturities of approximately 4 and 19 years, respectively. These investments have characteristics similar to short-term investments, because at pre-determined intervals, generally ranging from 30 to 35 days, there is a new auction process at which the interest rates for these securities are reset to current interest rates. At the end of such period, the Company chooses to roll-over its holdings or redeem the investments for cash. A market maker facilitates the redemption of the securities and the underlying issuers are not required to redeem the investment within 365 days. Interest earned from these investments is recorded in interest income.

During the fourth quarter of the fiscal year ended April 30, 2008, the Company began experiencing failed auctions on some of its auction rate securities. A failed auction occurs when a buyer for the securities cannot be obtained and the market maker does not buy the security for its own account. The Company continues to earn interest on the investments that failed to settle at auction, at the maximum contractual rate until the next auction occurs. In the event the Company needs to access funds invested in these auction rate securities, the Company may not be able to liquidate these securities at the fair value recorded on October 31, 2015, until a future auction of these securities is successful or a buyer is found outside of the auction process.

As a result of the failed auctions, the fair values of these securities are estimated utilizing a discounted cash flow analysis as of October 31, 2015. The analysis considers, among other items, the collateralization underlying the security investments, the creditworthiness of the counterparty, the timing of expected future cash flows, and the estimated date upon which the security is expected to have a successful auction. Based on the Company's ability to access its cash and cash equivalents, expected operating cash flows, and other sources of cash, the Company does not anticipate that the current lack of liquidity of these investments will affect its ability to operate the business in the ordinary course. The Company believes the current lack of liquidity of these investments is temporary and expects that the securities will be redeemed or refinanced at some point in the future. The Company will continue to monitor the value of its auction rate securities at each reporting period for a possible impairment if a further decline in fair value occurs. The auction rate securities have been in an unrealized loss position for more than 12 months. The Company has the ability and the intent to hold these investments until a recovery of fair value, which may be at maturity and as of October 31, 2015, the Company did not consider these investments to be other-than-temporarily impaired.

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The amortized cost, gross unrealized gains, gross unrealized losses, and estimated fair value of the auction rate securities as of October 31, 2015, were as follows (in thousands):

	Amortized Cost		Gross Unrealized Gains		Gross Unrealized Losses		Fair Value
Auction rate securities	\$ 3,100	\$		\$	(335)	\$	2,765
Total available-for-sale investments	\$ 3,100	\$		\$	(335)	\$	2,765

The amortized cost, gross unrealized gains, gross unrealized losses, and estimated fair value of the auction rate securities as of April 30, 2015, were as follows (in thousands):

	Amortized Cost		Gross Unrealized Gains		Gross Unrealized Losses		Fair Value
Auction rate securities	\$ 3,200	\$		\$	(359)	\$	2,841
Total available-for-sale investments	\$ 3,200	\$		\$	(359)	\$	2,841

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AeroVironment, Inc.

Notes to Consolidated Financial Statements (Unaudited)

The amortized cost and fair value of the auction rate securities by contractual maturity at October 31, 2015, were as follows (in thousands):

	Cost		Fair Value	
Due one through five years	\$	1,100	\$	1,055
Due after 10 years		2,000		1,710
Total	\$	3,100	\$	2,765

Equity Securities

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

At August 1, 2015, the Company reviewed these shares for impairment based on criteria that included the extent to which the investment's carrying value exceeds its related market value, the duration of the market decline, uncertainty as to the recovery period due to sustained losses of the investee and the Company's intent to hold its investment until recovery. In the three months ended August 1, 2015, the Company determined it was in its best interests to liquidate the remaining shares held. As a result, during the three months ended August 1, 2015, the Company recorded an other-than-temporary-impairment loss of \$2,186,000 related to the Company's investment in the CybAero shares which was recorded to Other expense in the consolidated statement of operations. As a result of recording the impairment charge, the investment's fair value became its new cost basis. During the three months ended October 31, 2015, and the three and six months ended August 2, 2014 there was no impairment charge recorded.

In August 2015, the Company sold its remaining shares in CybAero in a private sale at the price of 12.00 SEK per share, resulting in proceeds of approximately \$777,000. During the three and six months ended October 31, 2015, the Company realized gains on the sale of CybAero shares of \$155,000 and \$207,000, respectively, based on the difference between the original conversion price of 9.41 SEK per share and the sales price at the time of sale, inclusive of the final sale of all shares. During the three and six months ended November 1, 2014, the Company realized gains on the sale of CybAero shares of \$244,000 and \$4,147,000, respectively. At October 31, 2015, the Company did not hold any CybAero stock.

The amortized cost, gross unrealized gains, gross unrealized losses, and estimated fair value of the equity securities as of April 30, 2015, were as follows (in thousands):

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	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Equity securities	\$ 3,357	\$	\$ (1,884)	\$ 1,473
Total available-for-sale investments	\$ 3,357	\$	\$ (1,884)	\$ 1,473

3. Fair Value Measurements

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

- Level 1 Inputs to the valuation based upon quoted prices (unadjusted) for identical assets or liabilities in active markets that are accessible as of the measurement date.
- Level 2 Inputs to the valuation include quoted prices in either markets that are not active, or in active markets for similar assets or liabilities, inputs other than quoted prices that are observable, and inputs that are derived principally from or corroborated by observable market data.
- Level 3 Inputs to the valuation that are unobservable inputs for the asset or liability.

Table of Contents**AeroVironment, Inc.****Notes to Consolidated Financial Statements (Unaudited)**

The Company's financial assets measured at fair value on a recurring basis at October 31, 2015, were as follows (in thousands):

Description	Fair Value Measurement Using			Total
	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)	
Auction rate securities	\$	\$	\$ 2,765	\$ 2,765
Total	\$	\$	\$ 2,765	\$ 2,765

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

Description	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)
Balance at May 1, 2015	\$ 2,841
Transfers to Level 3	
Total gains (realized or unrealized)	
Included in earnings	
Included in other comprehensive loss	24
Purchases, issuances and settlements, net	(100)
Balance at October 31, 2015	\$ 2,765
The amount of total gains or (losses) for the period included in earnings (or change in net assets) attributable to the change in unrealized gains or losses relating to assets still held at October 31, 2015	\$

The auction rate securities are valued using a discounted cash flow model. The analysis considers, among other items, the collateralization underlying the security investments, the creditworthiness of the counterparty, the timing of expected future cash flows, and the estimated date upon which the security is expected to have a successful auction. As of October 31, 2015, the inputs used in the Company's discounted cash flow analysis included current coupon rates of 0.16% and 0.13%, estimated redemption periods of 4 and 19 years and discount rates of 4.30% and 14.60%. The discount rates were based on market rates for municipal bond securities, as adjusted for a risk premium to reflect the lack of liquidity of these investments.

4. Inventories, net

Inventories consist of the following (in thousands):

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	October 31, 2015	April 30, 2015
Raw materials	\$ 14,978	\$ 13,325
Work in process	8,257	5,140
Finished goods	28,937	25,537
Inventories, gross	52,172	44,002
Reserve for inventory obsolescence	(3,836)	(4,588)
Inventories, net	\$ 48,336	\$ 39,414

5. Warranty Reserves

The Company accrues an estimate of its exposure to warranty claims based upon both current and historical product sales data and warranty costs incurred. The warranty reserve is included in other current liabilities. The related expense is included in cost of sales. Warranty reserve activity is summarized as follows for the three and six months ended October 31, 2015 and November 1, 2014 (in thousands):

	Three Months Ended		Six Months Ended	
	October 31, 2015	November 1, 2014	October 31, 2015	November 1, 2014
Beginning balance	\$ 2,029	\$ 1,273	\$ 2,653	\$ 1,280
Warranty expense	1,001	1,027	1,708	1,409
Changes in estimates related to pre-existing warranties			(424)	
Warranty claims settled	(692)	(341)	(1,599)	(730)
Ending balance	\$ 2,338	\$ 1,959	\$ 2,338	\$ 1,959

Table of Contents**AeroVironment, Inc.****Notes to Consolidated Financial Statements (Unaudited)****6. Accumulated Other Comprehensive Loss and Reclassifications Adjustments**

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

	Available-for-Sale Securities	Accumulated Other Comprehensive Loss
Balance, net of \$834 of taxes, as of April 30, 2015	\$ (1,358)	\$ (1,358)
Reclassifications out of accumulated other comprehensive loss, net of \$754 of taxes	1,130	1,130
Unrealized gains, net of \$18 of taxes	27	27
Balance, net of \$134 of taxes, as of October 31, 2015	\$ (201)	\$ (201)

7. Customer-Funded Research & Development

Customer-funded R&D costs are incurred pursuant to contracts (revenue arrangements) to perform R&D activities according to customer specifications. These costs are direct contract costs and are expensed to cost of sales when the corresponding revenue is recognized, which is generally as the R&D services are performed. Revenue from customer-funded R&D was approximately \$10,234,000 and \$26,761,000 for the three and six months ended October 31, 2015, respectively. Revenue from customer-funded R&D was approximately \$5,599,000 and \$9,913,000 for the three and six months ended November 1, 2014, respectively.

8. Income Taxes

For the three and six months ended October 31, 2015, the Company recorded a provision (benefit) for income taxes of \$2,560,000 and \$(1,688,000), respectively, yielding an effective tax rate of 36.7% and 39.7%, respectively. For the three and six months ended November 1, 2014, the Company recorded a benefit for income taxes of \$1,619,000 and \$3,680,000, respectively, yielding an effective tax rate of 35.8% and 36.1%, respectively.

9. Government Contract Reserves

During the three and six months ended October 31, 2015, the Company entered into settlement agreements with DCMA related to the Company's incurred cost claims for fiscal years 2007 through 2009. As a result of the settlement agreements, the Company paid \$50,000 and reversed the remaining reserve amount of \$3,499,000 related to those fiscal years as a credit to cost of sales, allocated as \$3,111,000 to the UAS segment and

\$388,000 to the EES segment.

10. Share Repurchase

In September 2015, the Company's Board of Directors authorized a program to repurchase up to \$25,000,000 of the Company's common stock with no specified termination date for the program. During the three and six months ended October 31, 2015, the Company repurchased and retired 183,261 shares of the Company's common stock for a total of \$3,756,000. All shares repurchased were executed in the open market and no shares were repurchased from related parties. Repurchased shares were retired and assumed the status of authorized and unissued shares.

Table of Contents**AeroVironment, Inc.****Notes to Consolidated Financial Statements (Unaudited)****11. Segment Data**

The Company's product segments are as follows:

- **Unmanned Aircraft Systems** The UAS segment focuses primarily on the design, development, production, support and operation of innovative UAS and tactical missile systems that provide situational awareness, multi-band communications, force protection and other mission effects to increase the security and effectiveness of the operations of the Company's customers.
- **Efficient Energy Systems** The EES segment focuses primarily on the design, development, production, marketing, support and operation of innovative efficient electric energy systems that address the growing demand for electric transportation solutions.

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

	Three Months Ended		Six Months Ended	
	October 31, 2015	November 1, 2014	October 31, 2015	November 1, 2014
Revenue:				
UAS	\$ 56,589	\$ 43,045	\$ 96,756	\$ 84,231
EES	8,142	9,619	15,025	20,299
Total	64,731	52,664	111,781	104,530
Cost of sales:				
UAS	28,314	27,575	54,780	58,590
EES	4,884	7,218	9,445	14,015
Total	33,198	34,793	64,225	72,605
Gross margin:				
UAS	28,275	15,470	41,976	25,641
EES	3,258	2,401	5,580	6,284
Total	31,533	17,871	47,556	31,925
Selling, general and administrative	14,733	13,470	29,989	26,873

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Research and development	9,897	8,531	19,728	15,655
Income (loss) from operations	6,903	(4,130)	(2,161)	(10,603)
Other income (expense):				
Interest income	268	193	492	405
Other (expense) income	(192)	(583)	(2,581)	8
Income (loss) before income taxes	\$ 6,979	\$ (4,520)	\$ (4,250)	\$ (10,190)

12. Subsequent Events

On December 4, 2015, the Compensation Committee of the Board of Directors approved entering into a Severance Protection Agreement (the Agreement) with each of the Company's named executive officers which provides for the payment of certain benefits to each officer in connection with a change in control event and/or the termination of the officer's employment in a non-change in control event. The term of each Agreement will commence on the date the Agreement is executed and continue until December 31, 2018. If a change of control (as defined in the Agreement) occurs during the term of the Agreement, the term will be extended to the date that is 18 months after the date of the occurrence of such change in control.

Upon termination of the officer's employment by the Company without cause or by the officer for good reason generally within three months before a change in control event or within 18 months afterwards, each officer will be entitled to receive a one-time cash payment as defined under each officer's Agreement. Each officer will also be entitled to the continuation of certain employee welfare plan benefits (medical, dental and life insurance) for a period of 12 months. In addition, the vesting and exercisability of any outstanding stock options and restricted stock awards will be accelerated.

Upon termination by the Company for any reason other than cause in a context that does not involve a change in control, each officer will be entitled to a one-time cash payment as defined by each officer's Agreement, and the continuation of certain employee welfare plan benefits (as described earlier) for a period of 12 months. The terms of this severance benefit are identical for each officer except the Chief Executive Officer, who is entitled to receive these benefits in the event he terminates his employment for good cause as defined in the Agreement.

To receive the severance benefits described above, the officer must execute a full release of any and all claims against the Company and comply with certain obligations specified in the Agreement.

In addition to the severance benefits for officers described above, the Compensation Committee of the Board of Directors also approved an Employee Change in Control Equity Acceleration program that would accelerate the vesting and exercisability of stock options and restricted stock awards held by any Company employee on a double trigger basis similar to the treatment of equity awards of the officers. Under the program, if an employee's employment is terminated by the Company or a successor for a reason other than cause within 18 months after a change in control, the vesting and exercisability of all equity awards held by the employee would accelerate and the awards would become fully vested and exercisable.

On December 5, 2015, the Board of Directors approved entering into a letter agreement with each non-employee director that provides for the acceleration of vesting and exercisability of all Company stock options and restricted stock awards held by the director upon the completion of a change in control.

The Company determined that the actions taken by the Board of Directors and its Committee had no impact on the Company's consolidated financial statements as of, and for the three and six months ended October 31, 2015.

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

This section and other parts of this Quarterly Report on Form 10-Q contain forward-looking statements that involve risks and uncertainties. In some cases, forward-looking statements can be identified by words such as anticipates, believes, could, estimates, expects, intends, may, potential, predicts, projects, should, will, would or similar expressions. Such forward-looking statements are based on current expectations, estimates and projections about our industry, our management's beliefs and assumptions made by our management. Forward-looking statements are not guarantees of future performance and our actual results may differ significantly from the results discussed in the forward-looking statements. Factors that might cause such differences include, but are not limited to, those discussed in Part II, Item 1A, Risk Factors.

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

Critical Accounting Policies and Estimates

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

There have been no material changes made to the critical accounting estimates during the periods presented in the consolidated financial statements from those disclosed in the Form 10-K for the fiscal year ended April 30, 2015.

We review cost performance and estimates to complete at least quarterly and in many cases more frequently. Adjustments to original estimates for a contract's revenue, estimated costs at completion and estimated profit or loss are often required as work progresses under a contract, as experience is gained and as more information is obtained, even though the scope of work required under the contract may not change, or if contract modifications occur. The impact of revisions in profit estimates for all types of contracts are recognized on a cumulative catch-up basis in the period in which the revisions are made. During the three and six months ended October 31, 2015 and November 1, 2014, changes in accounting estimates on fixed-price contracts recognized using the percentage of completion method of accounting are presented below.

For the three months ended October 31, 2015 and November 1, 2014, favorable and unfavorable cumulative catch-up adjustments included in cost of sales were as follows (in thousands):

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	Three Months Ended	
	October 31, 2015	November 1, 2014
Gross favorable adjustments	\$ 499	\$ 710
Gross unfavorable adjustments	(125)	(796)
Net favorable (unfavorable) adjustments	\$ 374	\$ (86)

For the three months ended October 31, 2015, favorable cumulative catch-up adjustments of \$0.5 million were primarily due to final cost adjustments on 154 contracts, which individually were not material. For the same period, unfavorable cumulative catch-up adjustments of \$0.1 million were primarily related to higher than expected costs on 96 contracts, which individually were not material.

For the three months ended November 1, 2014, favorable cumulative catch-up adjustments of \$0.7 million were primarily due to final cost adjustments on 50 contracts, which individually were not material. For the same period, unfavorable cumulative catch-up adjustments of \$0.8 million were primarily related to higher than expected costs on 164 contracts, which individually were not material.

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For the six months ended October 31, 2015 and November 1, 2014, favorable and unfavorable cumulative catch-up adjustments included in cost of sales were as follows (in thousands):

	Six Months Ended	
	October 31, 2015	November 1, 2014
Gross favorable adjustments	\$ 437	\$ 991
Gross unfavorable adjustments	(207)	(1,156)
Net favorable (unfavorable) adjustments	\$ 230	\$ (165)

For the six months ended October 31, 2015, favorable cumulative catch-up adjustments of \$0.4 million were primarily due to final cost adjustments on 136 contracts, which individually were not material. For the same period, unfavorable cumulative catch-up adjustments of \$0.2 million were primarily related to higher than expected costs on 88 contracts, which individually were not material.

For the six months ended November 1, 2014, favorable cumulative catch-up adjustments of \$1.0 million were primarily due to final cost adjustments on 24 contracts, which individually were not material. For the same period, unfavorable cumulative catch-up adjustments of \$1.2 million were primarily related to higher than expected costs on 159 contracts, which individually were not material.

Fiscal Periods

Due to our fixed year end date of April 30, our first and fourth quarters each consist of approximately 13 weeks. The second and third quarters each consist of exactly 13 weeks. Our first three quarters end on a Saturday. Our 2016 fiscal year ends on April 30, 2016 and our fiscal quarters end on August 1, 2015, October 31, 2015 and January 30, 2016.

Results of Operations

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

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

Three Months Ended October 31, 2015 Compared to Three Months Ended November 1, 2014

