

AeroVironment Inc  
Form 10-Q  
March 05, 2014  
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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

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**FORM 10-Q**

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

**For the quarterly period ended January 25, 2014**

**OR**

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

**For the transition period from            to**

**Commission File Number: 001-33261**

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# 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.)

**181 W. Huntington Drive, Suite 202  
Monrovia, California**

(Address of principal executive offices)

**91016**

(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)

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

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

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

Large accelerated filer

Accelerated filer

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

Smaller reporting company

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

As of February 21, 2014, the number of shares outstanding of the registrant's common stock, \$0.0001 par value, was 22,785,334.



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**AeroVironment, Inc.**

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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)**

|  | <b>January 25,<br/>2014<br/>(Unaudited)</b> | <b>April 30,<br/>2013</b> |
|--|---|---------------------------|
| <b>Assets</b>  |   |                           |
| Current assets:  |   |                           |
| Cash and cash equivalents  | \$ 92,749                                   | \$ 75,332                 |
| Short-term investments   | 74,830                                      | 73,241                    |
| Accounts receivable, net of allowance for doubtful accounts of \$1,108 at January 25, 2014 and \$936 at April 30, 2013 | 42,617                                      | 19,770                    |
| Unbilled receivables and retentions  | 8,636                                       | 11,304                    |
| Inventories, net   | 55,441                                      | 62,561                    |
| Income tax receivable  | 5,852                                       | 11,777                    |
| Deferred income taxes  | 5,499                                       | 5,166                     |
| Prepaid expenses and other current assets  | 3,755                                       | 4,303                     |
| Total current assets   | 289,379                                     | 263,454                   |
| Long-term investments  | 45,877                                      | 68,916                    |
| Property and equipment, net  | 24,492                                      | 24,429                    |
| Deferred income taxes  | 5,548                                       | 5,606                     |
| Other assets   | 1,585                                       | 1,060                     |
| Total assets   | \$ 366,881                                  | \$ 363,465                |
| <b>Liabilities and Stockholders Equity</b>   |   |                           |
| Current liabilities:   |   |                           |
| Accounts payable   | \$ 15,135                                   | \$ 16,144                 |
| Wages and related accruals   | 10,718                                      | 12,116                    |
| Customer advances  | 3,642                                       | 7,519                     |
| Other current liabilities  | 6,486                                       | 6,408                     |
| Total current liabilities  | 35,981                                      | 42,187                    |
| Deferred rent  | 1,031                                       | 771                       |
| Liability for uncertain tax positions  | 5,211                                       | 5,321                     |
| 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 22,765,820 at January 25, 2014 and 22,614,315 at April 30, 2013                          | 2   | 2                         |
| Additional paid-in capital   | 134,251                                     | 130,527                   |

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|  |            |            |
|--|------------|------------|
| Accumulated other comprehensive loss       | (618)      | (705)      |
| Retained earnings                          | 191,023    | 185,362    |
| Total stockholders' equity                 | 324,658    | 315,186    |
| Total liabilities and stockholders' equity | \$ 366,881 | \$ 363,465 |

See accompanying notes to consolidated financial statements (unaudited).

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

|   | Three Months Ended  |                     | Nine Months Ended   |                     |
|---|---------------------|---------------------|---------------------|---------------------|
|   | January 25,<br>2014 | January 26,<br>2013 | January 25,<br>2014 | January 26,<br>2013 |
| <b>Revenue:</b>                             |                     |                     |                     |                     |
| Product sales                               | \$ 57,041           | \$ 23,496           | \$ 135,752          | \$ 104,601          |
| Contract services                           | 12,180              | 23,591              | 42,453              | 81,441              |
|   | 69,221              | 47,087              | 178,205             | 186,042             |
| <b>Cost of sales:</b>                       |                     |                     |                     |                     |
| Product sales                               | 33,193              | 14,281              | 85,891              | 63,055              |
| Contract services                           | 8,976               | 13,133              | 28,839              | 48,173              |
|   | 42,169              | 27,414              | 114,730             | 111,228             |
| Gross margin                                | 27,052              | 19,673              | 63,475              | 74,814              |
| Selling, general and administrative         | 13,168              | 10,433              | 38,711              | 37,230              |
| Research and development                    | 5,241               | 10,306              | 19,292              | 27,828              |
| Income (loss) from operations               | 8,643               | (1,066)             | 5,472               | 9,756               |
| <b>Other income (expense):</b>              |                     |                     |                     |                     |
| Interest income                             | 197                 | 164                 | 597                 | 498                 |
| Other income (expense)                      | 4,675               | 49                  | (1,026)             | 49                  |
| Income (loss) before income taxes           | 13,515              | (853)               | 5,043               | 10,303              |
| Provision (benefit) for income taxes        | 2,299               | (4,722)             | (618)               | (918)               |
| Net income                                  | \$ 11,216           | \$ 3,869            | \$ 5,661            | \$ 11,221           |
| <b>Earnings per share data:</b>             |                     |                     |                     |                     |
| Basic                                       | \$ 0.50             | \$ 0.17             | \$ 0.25             | \$ 0.51             |
| Diluted                                     | \$ 0.49             | \$ 0.17             | \$ 0.25             | \$ 0.50             |
| <b>Weighted average shares outstanding:</b> |                     |                     |                     |                     |
| Basic                                       | 22,321,368          | 22,142,917          | 22,278,225          | 22,035,007          |
| Diluted                                     | 22,883,583          | 22,408,377          | 22,722,795          | 22,375,126          |

See accompanying notes to consolidated financial statements (unaudited).

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**AeroVironment, Inc.**

**Consolidated Statements of Comprehensive Income (Unaudited)**

**(In thousands)**

|  | <b>Three Months Ended</b>   |                             | <b>Nine Months Ended</b>    |                             |
|--|-----------------------------|-----------------------------|-----------------------------|-----------------------------|
|  | <b>January 25,<br/>2014</b> | <b>January 26,<br/>2013</b> | <b>January 25,<br/>2014</b> | <b>January 26,<br/>2013</b> |
| Net income                                 | \$ 11,216                   | \$ 3,869                    | \$ 5,661                    | \$ 11,221                   |
| Other comprehensive income:                |                             |                             |                             |                             |
| Unrealized gain on investments, net of tax | 58                          | 15                          | 87                          | 42                          |
| Total comprehensive income                 | \$ 11,274                   | \$ 3,884                    | \$ 5,748                    | \$ 11,263                   |

See accompanying notes to consolidated financial statements (unaudited).



Table of Contents**AeroVironment, Inc.****Consolidated Statements of Cash Flows (Unaudited)****(In thousands)**

|   | <b>Nine Months Ended</b> |                    |
|---|--------------------------|--------------------|
|   | <b>January 25,</b>       | <b>January 26,</b> |
|   | <b>2014</b>              | <b>2013</b>        |
| <b>Operating activities</b>   |                          |                    |
| Net income  | \$ 5,661                 | \$ 11,221          |
| Adjustments to reconcile net income to cash provided by operating activities:   |                          |                    |
| Depreciation and amortization   | 6,799                    | 8,340              |
| Provision for doubtful accounts   | 269                      | 338                |
| Deferred income taxes   | (333)                    | (407)              |
| Stock-based compensation  | 2,687                    | 2,629              |
| Change in fair value of conversion feature of convertible bonds   | 1,032                    |                    |
| Unrealized foreign currency gain  |                          | (53)               |
| Tax benefit from exercise of stock options  | 304                      | 1,536              |
| Changes in operating assets and liabilities:  |                          |                    |
| Accounts receivable   | (23,116)                 | 24,479             |
| Unbilled receivables and retentions   | 2,668                    | 11,625             |
| Inventories   | 7,120                    | (20,058)           |
| Income tax receivable   | 5,925                    | (8,349)            |
| Other assets  | 662                      | (282)              |
| Accounts payable  | (1,009)                  | (4,436)            |
| Other liabilities   | (5,197)                  | (21,518)           |
| Net cash provided by operating activities   | 3,472                    | 5,065              |
| <b>Investing activities</b>   |                          |                    |
| Acquisitions of property and equipment  | (6,751)                  | (6,528)            |
| Acquisitions of distribution and licensing rights   | (750)                    | (850)              |
| Investment in CybAero AB convertible notes  |                          | (3,037)            |
| Net redemptions of held-to-maturity investments   | 20,388                   | 4,690              |
| Net sales of available-for-sale investments   | 175                      | 250                |
| Net cash provided by (used in) investing activities   | 13,062                   | (5,475)            |
| <b>Financing activities</b>   |                          |                    |
| Exercise of stock options   | 883                      | 165                |
| Net cash provided by financing activities   | 883                      | 165                |
| Net increase (decrease) in cash and cash equivalents  | 17,417                   | (245)              |
| Cash and cash equivalents at beginning of period  | 75,332                   | 64,220             |
| Cash and cash equivalents at end of period  | \$ 92,749                | \$ 63,975          |
| Supplemental disclosure:  |                          |                    |
| Unrealized gain on long-term investments recorded in other comprehensive income, net of deferred taxes of \$57 and \$28, respectively | \$ 87                    | \$ 42              |
| Reclassification from share-based liability compensation to equity  | \$                       | \$ 401             |

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 and efficient energy systems 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 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 accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments, consisting only of normal recurring adjustments necessary for a fair presentation with respect to the interim financial statements have been included. The results of operations for the three and nine months ended January 25, 2014 are not necessarily indicative of the results for the full year ending April 30, 2014. For further information, refer to the consolidated financial statements and footnotes thereto for the year ended April 30, 2013, included in the Company's Annual Report on Form 10-K.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States 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 significant intercompany accounts and transactions have been eliminated.

*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

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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)*****Earnings Per Share***

Basic earnings per share is computed using the weighted-average number of common shares outstanding, excluding shares of unvested restricted stock. The dilutive effect of potential common shares outstanding is included in diluted earnings per share and excludes any anti-dilutive effects of options, shares of unvested restricted stock and restricted stock units.

The reconciliation of basic to diluted shares is as follows:

|   | <b>Three Months Ended</b>   |                             | <b>Nine Months Ended</b>    |                             |
|---|-----------------------------|-----------------------------|-----------------------------|-----------------------------|
|   | <b>January 25,<br/>2014</b> | <b>January 26,<br/>2013</b> | <b>January 25,<br/>2014</b> | <b>January 26,<br/>2013</b> |
| Denominator for basic earnings per share:   |                             |                             |                             |                             |
| Weighted average common shares outstanding, excluding unvested restricted stock                 | 22,321,368                  | 22,142,917                  | 22,278,225                  | 22,035,007                  |
| Dilutive effect of employee stock options, unvested restricted stock and restricted stock units | 562,215                     | 265,460                     | 444,570                     | 340,119                     |
| Denominator for diluted earnings per share  | 22,883,583                  | 22,408,377                  | 22,722,795                  | 22,375,126                  |

During the three and nine months ended January 25, 2014 and January 26, 2013, certain shares reserved for issuance upon exercise of stock options, shares of unvested restricted stock and restricted stock units were not included in the computation of diluted earnings per share because their inclusion would have been anti-dilutive. The number of shares reserved for issuance upon exercise of stock options, shares of unvested restricted stock and restricted stock units that met this anti-dilutive criterion for the three months ended January 25, 2014 and January 26, 2013 was approximately 24,000 and 6,000, respectively. The number of shares reserved for issuance upon exercise of stock options, shares of unvested restricted stock and restricted stock units that met this anti-dilutive criterion for the nine months ended January 25, 2014 and January 26, 2013 was approximately 56,000 and 4,000, respectively.

***Recently Issued Accounting Standards***

On May 1, 2013, the Company adopted changes in accordance with guidance issued by the Financial Accounting Standards Board ( FASB ), which requires additional disclosures for the reclassification of significant amounts from accumulated comprehensive income to net income. This guidance requires that certain significant amounts be presented either on the face of the consolidated statements of income or in a single note. For other amounts, the Company is required to cross-reference disclosures that provide additional detail about such amounts. The adoption of these changes did not have a material impact on the Company's consolidated financial statements.

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In July 2013, the FASB issued guidance regarding the classification of an unrecognized tax benefit as a reduction of a deferred tax asset when a net operating loss carry-forward, a similar tax loss, or a tax credit carry-forward exists. This guidance became effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. Early adoption and retrospective application is permitted. The adoption of this change is not expected to have a material impact on the Company's consolidated financial statements.

### 2. Investments

Investments consist of the following (in thousands):

|   | January 25,<br>2014 | April 30,<br>2013 |
|---|---------------------|-------------------|
| <b>Short-term investments:</b>              |                     |                   |
| Held-to-maturity securities:                |                     |                   |
| Municipal securities                        | \$ 74,830           | \$ 73,241         |
| <b>Total short-term investments</b>         | <b>\$ 74,830</b>    | <b>\$ 73,241</b>  |
| <b>Long-term investments:</b>               |                     |                   |
| Held-to-maturity securities:                |                     |                   |
| Municipal securities                        | \$ 27,551           | \$ 54,158         |
| Certificates of deposit                     | 4,632               |                   |
| <b>Total held-to-maturity investments</b>   | <b>32,183</b>       | <b>54,158</b>     |
| Available-for-sale securities:              |                     |                   |
| Auction rate securities                     | 5,483               | 5,687             |
| Convertible bonds                           | 8,211               | 9,071             |
| <b>Total available-for-sale investments</b> | <b>13,694</b>       | <b>14,758</b>     |
| <b>Total long-term investments</b>          | <b>\$ 45,877</b>    | <b>\$ 68,916</b>  |

Table of Contents**AeroVironment, Inc.****Notes to Consolidated Financial Statements (Unaudited)****Held-To-Maturity Securities**

At January 25, 2014 and April 30, 2013, the balance of held-to-maturity securities consisted of state and local government municipal securities 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 January 25, 2014, were as follows (in thousands):

|                                    | Amortized<br>Cost |    | Gross<br>Unrealized<br>Gains |    | Gross<br>Unrealized<br>Losses |    | Fair Value |
|------------------------------------|-------------------|----|------------------------------|----|-------------------------------|----|------------|
| Municipal securities               | \$ 102,381        | \$ | 101                          | \$ | (2)                           | \$ | 102,480    |
| Certificates of deposit            | 4,632             |    |                              |    |                               |    | 4,632      |
| Total held-to-maturity investments | \$ 107,013        | \$ | 101                          | \$ | (2)                           | \$ | 107,112    |

The amortized cost, gross unrealized gains, gross unrealized losses, and estimated fair value of the held-to-maturity investments as of April 30, 2013, were as follows (in thousands):

|                                    | Amortized<br>Cost |    | Gross<br>Unrealized<br>Gains |    | Gross<br>Unrealized<br>Losses |    | Fair Value |
|------------------------------------|-------------------|----|------------------------------|----|-------------------------------|----|------------|
| Municipal securities               | \$ 127,399        | \$ | 49                           | \$ | (23)                          | \$ | 127,425    |
| Total held-to-maturity investments | \$ 127,399        | \$ | 49                           | \$ | (23)                          | \$ | 127,425    |

The amortized cost and fair value of the held-to-maturity securities by contractual maturity at January 25, 2014, were as follows (in thousands):

|  | Cost       |    | Fair Value |
|--|------------|----|------------|
| Due within one year                    | \$ 74,830  | \$ | 74,892     |
| Due after one year through three years | 32,183     |    | 32,220     |
| Total                                  | \$ 107,013 | \$ | 107,112    |

**Available-For-Sale Securities**

**Auction Rate Securities**

As of January 25, 2014, the entire balance of available-for-sale auction rate securities consisted of three investment grade auction rate municipal bonds with maturities ranging from 6 to 21 years. These investments have characteristics similar to short-term investments, because at pre-determined intervals, generally ranging from 30 to 35 days, there is a new auction process at which the interest rates for these securities are reset to current interest rates. At the end of such period, the Company chooses to roll-over its holdings or redeem the investments for cash. A market maker facilitates the redemption of the securities and the underlying issuers are not required to redeem the investment within 365 days. Interest earned from these investments is recorded in interest income.

During the fourth quarter of the fiscal year ended April 30, 2008, the Company began experiencing failed auctions on some of its auction rate securities. A failed auction occurs when a buyer for the securities cannot be obtained and the market maker does not buy the security for its own account. The Company continues to earn interest on the investments that failed to settle at auction, at the maximum contractual rate until the next auction occurs. In the event the Company needs to access funds invested in these auction rate securities, the Company may not be able to liquidate these securities at the fair value recorded on January 25, 2014 until a future auction of these securities is successful or a buyer is found outside of the auction process.

As a result of the failed auctions, the fair values of these securities are estimated utilizing a discounted cash flow analysis as of January 25, 2014. 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.



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

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 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 January 25, 2014, the Company did not consider these investments to be other-than-temporarily impaired.

The amortized cost, gross unrealized gains, gross unrealized losses, and estimated fair value of the available-for-sale investments as of January 25, 2014, were as follows (in thousands):

|                                      | <b>Amortized<br/>Cost</b> |    | <b>Gross<br/>Unrealized<br/>Gains</b> |    | <b>Gross<br/>Unrealized<br/>Losses</b> |    | <b>Fair Value</b> |
|--------------------------------------|---------------------------|----|---------------------------------------|----|--|----|-------------------|
| Auction rate securities              | \$ 6,575                  | \$ |                                       | \$ | (1,092)                                | \$ | 5,483             |
| Total available-for-sale investments | \$ 6,575                  | \$ |                                       | \$ | (1,092)                                | \$ | 5,483             |

The amortized cost, gross unrealized gains, gross unrealized losses, and estimated fair value of the available-for-sale investments as of April 30, 2013, were as follows (in thousands):

|                                      | <b>Amortized<br/>Cost</b> |    | <b>Gross<br/>Unrealized<br/>Gains</b> |    | <b>Gross<br/>Unrealized<br/>Losses</b> |    | <b>Fair Value</b> |
|--------------------------------------|---------------------------|----|---------------------------------------|----|--|----|-------------------|
| Auction rate securities              | \$ 6,750                  | \$ |                                       | \$ | (1,063)                                | \$ | 5,687             |
| Total available-for-sale investments | \$ 6,750                  | \$ |                                       | \$ | (1,063)                                | \$ | 5,687             |

The amortized cost and fair value of the auction rate securities by contractual maturity at January 25, 2014, were as follows (in thousands):

|                                 | <b>Cost</b> |    | <b>Fair Value</b> |
|---------------------------------|-------------|----|-------------------|
| Due after five through 10 years | \$ 1,300    | \$ | 1,207             |
| Due after 10 years              | 5,275       |    | 4,276             |
| Total                           | \$ 6,575    | \$ | 5,483             |

**Convertible Bonds**

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As of January 25, 2014, the entire balance of available-for-sale convertible bonds consisted of two convertible bonds. The two convertible bonds were issued by CybAero AB ( CybAero ), a publicly traded company in Sweden that develops and manufactures unmanned aerial vehicles. Each bond is in the amount of 10 million Swedish Kronor ( SEK ) and is convertible into 1 million CybAero shares at the conversion price of 10 SEK per share. The maturity date of each of the bonds is November 30, 2017 and each bond bears an annual interest rate of 5%.

The Company can exercise its conversion right at any time through October 31, 2017. CybAero can prepay the bonds with three months notice to the Company and the Company may exercise its conversion rights during such three-month period. If certain conditions are satisfied after November 30, 2015, CybAero can require the Company to convert the two bonds in their entirety into CybAero shares.

The convertible bonds each contain an embedded conversion feature which is bifurcated from the bond. The changes in the fair value of the embedded conversion feature are recorded in other income (expense) in the statement of income. Unrealized gains and losses associated with the bonds are excluded from earnings and reported as a separate component of stockholders' equity, net of deferred income taxes.

On May 14, 2013, CybAero effected a reverse stock split whereby every ten shares of CybAero were converted into one share. All amounts discussed as of January 25, 2014 reflect this reverse stock split.

On February 12, 2014, CybAero adjusted the conversion price of each convertible bond, pursuant to anti-dilution provisions in the convertible bonds agreement, from 10 SEK to 9.41 SEK and increased the number of shares per bond from 1,000,000 to 1,062,699. The adjusted conversion price and increased share count was effective February 12, 2014 and the impact of the change on fair value of the convertible bonds will be reflected in the fourth quarter and year ending April 30, 2014.

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

On February 28, 2014, the Company exercised its conversion right and notified CybAero that it will convert one convertible bond into CybAero common shares. The convertible bond is in the amount of 10 million SEK and is being converted into 1,062,699 common shares of CybAero at the conversion price of 9.41 SEK. CybAero has 30 days to register and deliver the common shares to the Company. The conversion will be reflected in the fourth quarter and year ending April 30, 2014.

The amortized cost, gross unrealized gains, gross unrealized losses, and estimated fair value of the available-for-sale convertible bonds as of January 25, 2014, were as follows (in thousands):

|                                      | Amortized<br>Cost |    | Gross<br>Unrealized<br>Gains |    | Gross<br>Unrealized<br>Losses |    | Fair Value |
|--------------------------------------|-------------------|----|------------------------------|----|-------------------------------|----|------------|
| Convertible bonds                    | \$ 3,037          | \$ | 5,174                        | \$ | \$                            | \$ | 8,211      |
| Total available-for-sale investments | \$ 3,037          | \$ | 5,174                        | \$ | \$                            | \$ | 8,211      |

The amortized cost, gross unrealized gains, gross unrealized losses, and estimated fair value of the available-for-sale convertible bonds as of April 30, 2013, were as follows (in thousands):

|                                      | Amortized<br>Cost |    | Gross<br>Unrealized<br>Gains |    | Gross<br>Unrealized<br>Losses |    | Fair Value |
|--------------------------------------|-------------------|----|------------------------------|----|-------------------------------|----|------------|
| Convertible bonds                    | \$ 3,037          | \$ | 6,173                        | \$ | (139)                         | \$ | 9,071      |
| Total available-for-sale investments | \$ 3,037          | \$ | 6,173                        | \$ | (139)                         | \$ | 9,071      |

The amortized cost and fair value of the convertible bonds by contractual maturity at January 25, 2014, were as follows (in thousands):

|                       | Cost     |    | Fair Value |
|-----------------------|----------|----|------------|
| Due within five years | \$ 3,037 | \$ | 8,211      |
| Total                 | \$ 3,037 | \$ | 8,211      |

**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:

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- 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.

The Company's financial assets measured at fair value on a recurring basis at January 25, 2014, were as follows (in thousands):

| Description             | Fair Value Measurement Using  |   |  | Total            |
|-------------------------|---|---|--|------------------|
|                         | Quoted prices in<br>active markets for<br>identical assets<br>(Level 1) | Significant<br>other<br>observable<br>inputs<br>(Level 2) | Significant<br>unobservable<br>inputs<br>(Level 3) |                  |
| Auction rate securities | \$  | \$  | \$ 5,483   | \$ 5,483         |
| Convertible bonds       |   | 5,140   | 3,071  | 8,211            |
| <b>Total</b>            | <b>\$</b>   | <b>\$ 5,140</b>   | <b>\$ 8,554</b>                                    | <b>\$ 13,694</b> |

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Due to the auction failures of the Company's auction rate securities that began in the fourth quarter of fiscal 2008, there are still no quoted prices in active markets for identical assets as of January 25, 2014. Therefore, the Company has classified its auction rate securities as Level 3 financial assets. 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):

| <b>Description</b>   | <b>Fair Value<br/>Measurements Using<br/>Significant<br/>Unobservable Inputs<br/>(Level 3)</b> |
|--|--|
| Balance at April 30, 2013  | \$ 8,585   |
| Transfers to Level 3   |  |
| Total gains (realized or unrealized)<br>Included in earnings   |  |
| Included in other comprehensive income   | 144  |
| Purchases, issuances and settlements, net  | (175)  |
| Balance at January 25, 2014  | \$ 8,554   |
| 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 January 25, 2014 | \$   |

The auction rate securities are valued using a discounted cash flow model. The analysis considers, among other items, the collateralization underlying the security investments, the creditworthiness of the counterparty, the timing of expected future cash flows, and the estimated date upon which the security is expected to have a successful auction. As of January 25, 2014, the inputs used in the Company's discounted cash flow analysis included current coupon rates ranging from 0.1% to 0.3%, estimated redemption periods of 6 to 21 years and discount rates of 7.4% to 19.6%. 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.

The bond components of the convertible bonds are considered level 3 assets and are valued using a discounted cash flow model. The analysis considers, among other items, the creditworthiness of the counterparty, the timing of expected future cash flows, and the maturity of the bonds. As of January 25, 2014, the inputs used in the Company's discounted cash flow analysis included a coupon rate of 5.0%, estimated redemption period of approximately four years and a discount rate of 5.4%.

The embedded conversion features of the convertible bonds are considered level 2 assets and are valued using a binomial option pricing model, which uses inputs such as CybAero's stock price, conversion price, volatility and risk-free interest rate.

**4. Inventories, net**

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Inventories consist of the following (in thousands):

|                                    | January 25,<br>2014 |         | April 30,<br>2013 |         |
|------------------------------------|---------------------|---------|-------------------|---------|
| Raw materials                      | \$                  | 15,023  | \$                | 12,845  |
| Work in process                    |                     | 7,961   |                   | 16,745  |
| Finished goods                     |                     | 37,292  |                   | 36,842  |
| Inventories, gross                 |                     | 60,276  |                   | 66,432  |
| Reserve for inventory obsolescence |                     | (4,835) |                   | (3,871) |
| Inventories, net                   | \$                  | 55,441  | \$                | 62,561  |

**5. Warranty Reserves**

The Company accrues an estimate of its exposure to warranty claims based upon both current and historical product sales data and warranty costs incurred. The warranty reserve is included in other current liabilities. The related expense is included in cost of sales. Warranty reserve activity is summarized as follows for the three and nine months ended January 25, 2014 and January 26, 2013 (in thousands):

|                         | Three Months Ended  |                     | Nine Months Ended   |                     |
|-------------------------|---------------------|---------------------|---------------------|---------------------|
|                         | January 25,<br>2014 | January 26,<br>2013 | January 25,<br>2014 | January 26,<br>2013 |
| Beginning balance       | \$ 1,640            | \$ 1,259            | \$ 1,514            | \$ 2,872            |
| Warranty expense        | 534                 | 500                 | 1,352               | 1,708               |
| Warranty claims settled | (317)               | (390)               | (1,009)             | (3,211)             |
| Ending balance          | \$ 1,857            | \$ 1,369            | \$ 1,857            | \$ 1,369            |

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

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

|                                |    | <b>Available-for-sale<br/>securities</b> |       | <b>Accumulated Other<br/>Comprehensive Loss</b> |
|--------------------------------|----|--|-------|---|
| Balance as of April 30, 2013   | \$ |  | (705) | \$ (705)  |
| Unrealized income              |    |  | 144   | 144   |
| Income taxes                   |    |  | (57)  | (57)  |
| Balance as of January 25, 2014 | \$ |  | (618) | \$ (618)  |

**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 \$5.0 million and \$21.9 million for the three and nine months ended January 25, 2014, respectively. Revenue from customer-funded R&D was approximately \$11.1 million and \$28.1 million for the three and nine months ended January 26, 2013, respectively.

**8. Income Taxes**

For the three and nine months ended January 25, 2014, the Company recorded a provision (benefit) for income taxes of \$2.3 million and \$(0.6) million, respectively, yielding an effective tax rate of 17.0% and (12.3)%, respectively. For the three and nine months ended January 26, 2013, the Company recorded a benefit for income taxes of \$4.7 million and \$0.9 million, respectively, yielding an effective tax rate of 553.6% and (8.9)%, respectively. The variance from statutory tax rates for the three and nine months ended January 25, 2014 and January 26, 2013 was primarily due to federal research and development tax credits.

**9. Segment Data**

The Company's product segments are as follows:

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- Unmanned Aircraft Systems ( UAS ) 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 ( EES ) 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.



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

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

|                                     | Three Months Ended  |                     | Nine Months Ended   |                     |
|-------------------------------------|---------------------|---------------------|---------------------|---------------------|
|                                     | January 25,<br>2014 | January 26,<br>2013 | January 25,<br>2014 | January 26,<br>2013 |
| <b>Revenue:</b>                     |                     |                     |                     |                     |
| UAS                                 | \$ 57,491           | \$ 37,665           | \$ 148,781          | \$ 151,904          |
| EES                                 | 11,730              | 9,422               | 29,424              | 34,138              |
| Total                               | 69,221              | 47,087              | 178,205             | 186,042             |
| <b>Cost of sales:</b>               |                     |                     |                     |                     |
| UAS                                 | 33,565              | 20,585              | 93,444              | 88,620              |
| EES                                 | 8,604               | 6,829               | 21,286              | 22,608              |
| Total                               | 42,169              | 27,414              | 114,730             | 111,228             |
| <b>Gross margin:</b>                |                     |                     |                     |                     |
| UAS                                 | 23,926              | 17,080              | 55,337              | 63,284              |
| EES                                 | 3,126               | 2,593               | 8,138               | 11,530              |
| Total                               | 27,052              | 19,673              | 63,475              | 74,814              |
| Selling, general and administrative | 13,168              | 10,433              | 38,711              | 37,230              |
| Research and development            | 5,241               | 10,306              | 19,292              | 27,828              |
| Income (loss) from operations       | 8,643               | (1,066)             | 5,472               | 9,756               |
| <b>Other income (expense):</b>      |                     |                     |                     |                     |
| Interest income                     | 197                 | 164                 | 597                 | 498                 |
| Other income (expense)              | 4,675               | 49                  | (1,026)             | 49                  |
| Income (loss) before income taxes   | \$ 13,515           | \$ (853)            | \$ 5,043            | \$ 10,303           |

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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.

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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, 2013.

### **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 2014 fiscal year ends on April 30, 2014 and our fiscal quarters end on July 27, 2013, October 26, 2013 and January 25, 2014.

### **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 January 25, 2014 Compared to Three Months Ended January 26, 2013*

|                                     | <b>Three Months Ended</b>   |                             |
|-------------------------------------|-----------------------------|-----------------------------|
|                                     | <b>January 25,<br/>2014</b> | <b>January 26,<br/>2013</b> |
| <b>Revenue:</b>                     |                             |                             |
| UAS                                 | \$ 57,491                   | \$ 37,665                   |
| EES                                 | 11,730                      | 9,422                       |
| Total                               | 69,221                      | 47,087                      |
| <b>Cost of sales:</b>               |                             |                             |
| UAS                                 | 33,565                      | 20,585                      |
| EES                                 | 8,604                       | 6,829                       |
| Total                               | 42,169                      | 27,414                      |
| <b>Gross margin:</b>                |                             |                             |
| UAS                                 | 23,926                      | 17,080                      |
| EES                                 | 3,126                       | 2,593                       |
| Total                               | 27,052                      | 19,673                      |
| Selling, general and administrative | 13,168                      | 10,433                      |
| Research and development            | 5,241                       | 10,306                      |
| Income (loss) from operations       | 8,643                       | (1,066)                     |
| <b>Other income:</b>                |                             |                             |
| Interest income                     | 197                         | 164                         |

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|                                   |    |        |    |       |
|-----------------------------------|----|--------|----|-------|
| Other income                      |    | 4,675  |    | 49    |
| Income (loss) before income taxes | \$ | 13,515 | \$ | (853) |

**Revenue.** Revenue for the three months ended January 25, 2014 was \$69.2 million, compared to \$47.1 million for the three months ended January 26, 2013, representing an increase of \$22.1 million, or 47%. UAS revenue increased by \$19.8 million, or 53%, to \$57.5 million for the three months ended January 25, 2014, primarily due to higher product deliveries of \$31.0 million, offset by lower customer-funded R&D revenue of \$5.9 million and lower service revenue of \$5.2 million. The increase in product deliveries was primarily due to higher deliveries of Raven and Puma systems and spares. The decrease in customer-funded R&D revenue was primarily due to the transition of Switchblade from a developmental program into low-rate production and no revenue associated with the Global Observer cost reimbursements. The decrease in service revenue was primarily due to reduced logistic services for small UAS. EES revenue increased by \$2.3 million, or 24%, to \$11.7 million for the three months ended January 25, 2014. The increase in EES revenue was primarily due to higher deliveries of passenger electric vehicle charging systems and industrial fast charge systems, offset by lower deliveries of electric vehicle test systems.

**Cost of Sales.** Cost of sales for the three months ended January 25, 2014 was \$42.2 million, compared to \$27.4 million for the three months ended January 26, 2013, representing an increase of \$14.8 million, or 54%. As a percentage of revenue, cost of sales increased from 58% to 61%. UAS cost of sales increased \$13.0 million for the three months ended January 25, 2014 due to higher sales volume.

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As a percentage of revenue, cost of sales for UAS increased from 55% to 58% due to lower absorption of manufacturing and engineering overhead support costs. EES cost of sales increased \$1.8 million, or 26%, to \$8.6 million for the three months ended January 25, 2014 due to higher sales volume. As a percentage of revenue, cost of sales for EES increased from 72% to 73%.

**Gross Margin.** Gross margin for the three months ended January 25, 2014 was \$27.1 million, compared to \$19.7 million for the three months ended January 26, 2013, representing an increase of \$7.4 million, or 38%. UAS gross margin increased \$6.8 million, or 40%, to \$23.9 million for the three months ended January 25, 2014, primarily due to higher sales volume. As a percentage of revenue, gross margin for UAS decreased from 45% to 42%, due to lower absorption of manufacturing and engineering overhead support costs. In addition, the three months ended January 26, 2013 included reimbursement costs for the Global Observer Joint Capability Technology Demonstration contract. EES gross margin increased \$0.5 million, or 21%, to \$3.1 million for the three months ended January 25, 2014, primarily due to higher sales volume. As a percentage of revenue, EES gross margin decreased from 28% to 27%.

**Selling, General and Administrative.** SG&A expense for the three months ended January 25, 2014 was \$13.2 million, or 19% of revenue, compared to SG&A expense of \$10.4 million, or 22% of revenue, for the three months ended January 26, 2013. SG&A expense for the three months ended January 26, 2013 included a reduction of accrued incentive compensation as a result of not achieving anticipated financial performance.

**Research and Development.** R&D expense for the three months ended January 25, 2014 was \$5.2 million, or 8% of revenue, compared to R&D expense of \$10.3 million, or 22% of revenue, for the three months ended January 26, 2013. The decrease was primarily due to lower spending on R&D initiatives.

**Interest Income.** Interest income was \$0.2 million for both the three months ended January 25, 2014 and January 26, 2013.

**Other Income.** Other income for the three months ended January 25, 2014 was \$4.7 million, compared to \$0 for the three months ended January 26, 2013. The increase was primarily due to a \$4.7 million increase in fair value of the embedded conversion feature of our convertible bonds investment.

**Income Tax Expense.** Our effective tax rate was 17.0% for the three months ended January 25, 2014, compared to a tax benefit rate of 553.6% for the three months ended January 26, 2013. The increase in tax expense was primarily due to higher income before income taxes for the three months ended January 25, 2014 compared to a loss before income taxes for the three months ended January 26, 2013.

**Nine Months Ended January 25, 2014 Compared to Nine Months Ended January 26, 2013**

| Nine Months Ended   |                     |
|---------------------|---------------------|
| January 25,<br>2014 | January 26,<br>2013 |

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|                                     |  |    |         |    |         |
|-------------------------------------|--|----|---------|----|---------|
| Revenue:                            |  |    |         |    |         |
| UAS                                 |  | \$ | 148,781 | \$ | 151,904 |
| EES                                 |  |    | 29,424  |    | 34,138  |
| Total                               |  |    | 178,205 |    | 186,042 |
| Cost of sales:                      |  |    |         |    |         |
| UAS                                 |  |    | 93,444  |    | 88,620  |
| EES                                 |  |    | 21,286  |    | 22,608  |
| Total                               |  |    | 114,730 |    | 111,228 |
| Gross margin:                       |  |    |         |    |         |
| UAS                                 |  |    | 55,337  |    | 63,284  |
| EES                                 |  |    | 8,138   |    | 11,530  |
| Total                               |  |    | 63,475  |    | 74,814  |
| Selling, general and administrative |  |    | 38,711  |    | 37,230  |
| Research and development            |  |    | 19,292  |    | 27,828  |
| Income from operations              |  |    | 5,472   |    | 9,756   |
| Other income (expense):             |  |    |         |    |         |
| Interest income                     |  |    | 597     |    | 498     |
| Other (expense) income              |  |    | (1,026) |    | 49      |
| Income before income taxes          |  | \$ | 5,043   | \$ | 10,303  |

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**Revenue.** Revenue for the nine months ended January 25, 2014 was \$178.2 million, compared to \$186.0 million for the nine months ended January 26, 2013, representing a decrease of \$7.8 million, or 4%. UAS revenue decreased by \$3.1 million, or 2%, to \$148.8 million for the nine months ended January 25, 2014, primarily due to lower service revenue of \$31.2 million and lower customer-funded R&D revenue of \$6.5 million, offset by higher product deliveries of \$34.6 million. The decrease in service revenue was primarily due to reduced logistic services for our small UAS systems. The decrease in customer-funded R&D revenue was primarily due to the transition of Switchblade from a developmental program into low-rate production. The increase in product deliveries was primarily due to higher deliveries of our Puma AE spares. EES revenue decreased by \$4.7 million, or 14%, to \$29.4 million for the nine months ended January 25, 2014. The decrease in EES revenue was primarily due to lower deliveries of electric vehicle test systems and industrial fast charge systems, offset by higher deliveries of passenger electric vehicle charging systems.

**Cost of Sales.** Cost of sales for the nine months ended January 25, 2014 was \$114.7 million, compared to \$111.2 million for the nine months ended January 26, 2013, representing an increase of \$3.5 million, or 3%. As a percentage of revenue, cost of sales increased from 60% to 64%. UAS cost of sales increased \$4.8 million, or 5%, to \$93.4 million for the nine months ended January 25, 2014. As a percentage of revenue, cost of sales for UAS increased from 58% to 63% due to lower absorption of manufacturing and engineering overhead support costs, which included severance costs associated with our organizational realignment. EES cost of sales decreased \$1.3 million, or 6%, to \$21.3 million for the nine months ended January 25, 2014, primarily due to lower sales volume. As a percentage of revenue, cost of sales for EES increased from 66% to 72%, primarily due to lower absorption of manufacturing and engineering overhead support costs, which included severance costs associated with our organizational realignment.

**Gross Margin.** Gross margin for the nine months ended January 25, 2014 was \$63.5 million, compared to \$74.8 million for the nine months ended January 26, 2013, representing a decrease of \$11.3 million, or 15%. UAS gross margin decreased \$7.9 million, or 13%, to \$55.3 million for the nine months ended January 25, 2014, primarily due to lower absorption of manufacturing and engineering overhead support costs, which included severance costs associated with our organizational realignment. As a percentage of revenue, gross margin for UAS decreased from 42% to 37%, primarily due to lower absorption of manufacturing and engineering overhead support costs, which included severance costs associated with our organizational realignment. EES gross margin decreased \$3.4 million, or 29%, to \$8.1 million for the nine months ended January 25, 2014, primarily due to lower sales volume. As a percentage of revenue, EES gross margin decreased from 34% to 28%, primarily due to lower absorption of manufacturing and engineering overhead support costs, which included severance costs associated with our organizational realignment.

**Selling, General and Administrative.** SG&A expense for the nine months ended January 25, 2014 was \$38.7 million, or 22% of revenue, compared to SG&A expense of \$37.2 million, or 20% of revenue, for the nine months ended January 26, 2013.

**Research and Development.** R&D expense for the nine months ended January 25, 2014 was \$19.3 million, or 11% of revenue, compared to R&D expense of \$27.8 million, or 15% of revenue, for the nine months ended January 26, 2013. The decrease was primarily due to lower spending on R&D initiatives.

**Interest Income.** Interest income was \$0.6 million for the nine months ended January 25, 2014, compared to interest income of \$0.5 million for the nine months ended January 26, 2013.

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**Other Expense.** Other expense for the nine months ended January 25, 2014 was \$1.0 million, compared to \$0 for the nine months ended January 26, 2013. The increase was primarily due to a \$1.0 million reduction in fair value of the embedded conversion feature of the convertible bonds investment.

**Income Tax Benefit.** Our tax benefit rate was 12.3% for the nine months ended January 25, 2014, compared to our tax benefit rate of 8.9% for the nine months ended January 26, 2013.

**Backlog.** We define funded backlog as unfilled firm orders for products and services for which funding currently is appropriated to us under the contract by the customer. As of January 25, 2014 and April 30, 2013, our funded backlog was approximately \$95.5 million and \$59.4 million, respectively.

In addition to our funded backlog, we also had unfunded backlog of \$23.6 million and \$76.6 million as of January 25, 2014 and April 30, 2013, respectively. We define unfunded backlog as the total remaining potential order amounts under sole-source cost reimbursable and fixed price contracts with multiple one-year options, and indefinite delivery indefinite quantity, or IDIQ, contracts. Unfunded backlog does not obligate the U.S. government to purchase goods or services. There can be no assurance that unfunded backlog will result in any orders in any particular period, if at all. Management believes that unfunded backlog does not provide a reliable measure of future estimated revenue under our contracts.



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

**Liquidity and Capital Resources**

We currently have no material cash commitments, except for normal recurring trade payables, accrued expenses and ongoing research and development costs, all of which we anticipate funding through our existing working capital and funds provided by operating activities. The majority of our purchase obligations are pursuant to funded contractual arrangements with our customers. In addition, we do not currently anticipate significant investment in property, plant and equipment, and we believe that our existing cash, cash equivalents, cash provided by operating activities and other financing sources will be sufficient to meet our anticipated working capital, capital expenditure and debt service requirements, if any, during the next twelve months. There can be no assurance, however, that our business will continue to generate cash flow at current levels. Nevertheless, we anticipate that existing sources of liquidity and cash flows from operations will be sufficient to satisfy our cash needs for the foreseeable future.

Our primary liquidity needs are for financing working capital, investing in capital expenditures, supporting product development efforts, introducing new products and enhancing existing products and services, and marketing acceptance and adoption of our products and services. Our future capital requirements, to a certain extent, are also subject to general conditions in or affecting the defense and electric vehicle industries and are subject to general economic, political, financial, competitive, legislative and regulatory factors that are beyond our control. Moreover, to the extent that existing cash, cash equivalents, cash from operations, and cash from short-term borrowing are insufficient to fund our future activities, we may need to raise additional funds through public or private equity or debt financing. To the extent we require additional funding, we cannot be certain that such funding will be available to us on acceptable terms, or at all. Although we are currently not a party to any material agreement or letter of intent with respect to potential investment in, or acquisitions of, businesses, services or technologies, we may enter into these types of arrangements in the future, which could also require us to seek additional equity or debt financing.

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

**Cash Flows**

The following table provides our cash flow data for the nine months ended January 25, 2014 and January 26, 2013 (in thousands):

|  | <b>Nine Months Ended</b>    |                             |
|--|-----------------------------|-----------------------------|
|  | <b>January 25,<br/>2014</b> | <b>January 26,<br/>2013</b> |

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|   | (Unaudited) |        |    |         |
|---|-------------|--------|----|---------|
| Net cash provided by operating activities           | \$          | 3,472  | \$ | 5,065   |
| Net cash provided by (used in) investing activities | \$          | 13,062 | \$ | (5,475) |
| Net cash provided by financing activities           | \$          | 883    | \$ | 165     |

**Cash Provided by Operating Activities.** Net cash provided by operating activities for the nine months ended January 25, 2014 decreased by \$1.6 million to \$3.5 million, compared to net cash provided by operating activities of \$5.1 million for the nine months ended January 26, 2013. This decrease in net cash provided by operating activities was primarily due to lower net income of \$5.6 million, lower depreciation and amortization of \$1.5 million, and lower tax benefits from stock option exercises of \$1.2 million, partially offset by lower working capital needs of \$5.6 million and a \$1.0 million reduction in fair value of the embedded conversion feature of our convertible bonds investment.

**Cash Provided by (Used in) Investing Activities.** Net cash provided by investing activities increased by \$18.5 million to \$13.1 million for the nine months ended January 25, 2014, compared to net cash used in investing activities of \$5.5 million for the nine months ended January 26, 2013. The increase in net cash provided by investing activities was primarily due to higher net redemptions of investments of \$15.6 million.

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**Cash Provided by Financing Activities.** Net cash provided by financing activities was \$0.9 million for the nine months ended January 25, 2014, compared to net cash provided by financing activities of \$0.2 million for the nine months ended January 26, 2013.

**Off-Balance Sheet Arrangements**

During the third quarter, there were no material changes in our off-balance sheet arrangements or contractual obligations and commercial commitments from those disclosed in the Form 10-K for the fiscal year ended April 30, 2013.

**Inflation**

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

**New Accounting Standards**

Please refer to Note 1 Organization and Significant Accounting Policies to our unaudited consolidated financial statements in Part I, Item 1 of this quarterly report for a discussion of new accounting pronouncements.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

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

***Interest Rate Risk***

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

***Foreign Currency Exchange Rate Risk***

Since a significant part of our sales and expenses are denominated in U.S. dollars, we have not experienced significant foreign exchange gains or losses to date, and do not expect to incur significant foreign exchange gains or losses in the future. We occasionally engage in forward contracts in foreign currencies to limit our exposure on non-U.S. dollar transactions.

#### **ITEM 4. CONTROLS AND PROCEDURES**

##### *Controls and Procedures*

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

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

As required by Rule 13a-15(b) under the Exchange Act, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures.

Based on the foregoing, our Chief Executive Officer and Chief Financial Officer concluded that, as of the end of the period covered by this report, our disclosure controls and procedures were effective and were operating at a reasonable assurance level.

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*Internal Control over Financial Reporting*

There were no changes in our internal control over financial reporting or in other factors identified in connection with the evaluation required by paragraph (d) of Exchange Act Rules 13a-15 or 15d-15 that occurred during the quarter ended January 25, 2014 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**PART II. OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

We are not currently a party to any material legal proceedings. We are, however, subject to lawsuits from time to time in the ordinary course of business.

**ITEM 1A. RISK FACTORS**

There have been no material changes to the risk factors disclosed under Part I, Item 1A, Risk Factors, in our Annual Report on Form 10-K for the fiscal year ended April 30, 2013. Please refer to that section for disclosures regarding the risks and uncertainties related to our business.

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

None.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

**ITEM 4. MINE SAFETY DISCLOSURES**

None.

**ITEM 5. OTHER INFORMATION**

None.

**ITEM 6. EXHIBITS**

| <b>Exhibit Number</b> | <b>Description</b>  |
|-----------------------|---|
| 10.1                  | First Amendment to Lease Agreement (900 Enchanted Way, Simi Valley, CA 93065) dated as of December 1, 2013, by and between the Company and Hillside III LLC, and related agreements     |
| 10.2                  | First Amendment to Lease Agreement (994 Flower Glen Street, Simi Valley, CA 93065) dated as of December 1, 2013, by and between the Company and Hillside II LLC, and related agreements |
| 10.3                  | Lease Agreement (996 Flower Glen Street, Simi Valley, CA 93065) dated as of December 1, 2013, by and between the Company and Hillside II LLC, and related agreements                    |
| 31.1                  | Certification of Chief Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended.  |
| 31.2                  | Certification of Chief Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended.  |
| 32                    | Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.          |
| 101.INS               | XBRL Instance Document.   |
| 101.SCH               | XBRL Taxonomy Extension Schema Document.  |
| 101.CAL               | XBRL Taxonomy Calculation Linkbase Document.  |
| 101.DEF               | XBRL Taxonomy Extension Definition Linkbase Document.   |
| 101.LAB               | XBRL Taxonomy Label Linkbase Document.  |
| 101.PRE               | XBRL Taxonomy Presentation Linkbase Document.   |

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**SIGNATURES**

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

Date: March 4, 2014

AEROVIRONMENT, INC.

By: /s/ Timothy E. Conver  
Timothy E. Conver  
Chairman, Chief Executive Officer and President  
(Principal Executive Officer)

/s/ Jikun Kim  
Jikun Kim  
Senior Vice President and Chief Financial Officer  
(Principal Financial and Accounting Officer)