

CYANOTECH CORP  
Form 10-K  
June 23, 2016

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

**Washington, D. C. 20549**

**FORM 10-K**

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

**For the Fiscal Year Ended March 31, 2016**

**Commission File Number 0-14602**

**CYANOTECH CORPORATION**

(Exact name of registrant as specified in its charter)

**Nevada**

(State or other jurisdiction of incorporation or organization)

**91-1206026**

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

**73-4460 Queen Kaahumanu Highway, Suite 102,  
Kailua-Kona, Hawaii**

(Address of principal executive offices)

**96740**

(Zip  
Code)

Registrant's telephone number, including area code: **(808) 326-1353**

Securities registered pursuant to Section 12(b) of the Act: **None** Name of each exchange on which registered: **NASDAQ Capital Market**

Securities registered pursuant to Section 12(g) of the Act:

**Common Stock, \$0.02 par value**  
(Title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.  
Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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 checkmark 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 (§229.405 of this chapter) during the preceding 12 months (or such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large accelerated filer

Accelerated filer

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

Smaller reporting company

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

The aggregate market value of the Registrant's Common Stock held by non-affiliates of the Registrant on September 30, 2015 was approximately \$33,244,974 based on the closing sale price of the Common Stock on the NASDAQ Capital Market on that date.

Number of shares outstanding of Registrant's Common Stock at June 23, 2016 was 5,648,264.

**DOCUMENTS INCORPORATED BY REFERENCE**

**Portions of the Registrant's Definitive Proxy Statement for its 2016 Annual Meeting of Stockholders, to be filed with the Securities and Exchange Commission on or prior to July 15, 2016 and to be used in connection with the Annual Meeting of Stockholders expected to be held on August 25, 2016, are incorporated by reference in Part III of this Form 10-K.**

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## FORWARD-LOOKING STATEMENTS

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

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

Statements relating to our business strategy;

Statements relating to our business objectives; and

Expectations concerning future operations, profitability, liquidity and financial resources.

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

Environmental restrictions, soil and water conditions, levels of sunlight and seasonal weather patterns, particularly heavy rain, wind and other hazards;

Consumer perception of our products due to adverse scientific research or findings, publicity regarding nutritional supplements, litigation, regulatory investigations or other events, conditions and circumstances involving the Company which receive national media coverage;

Effects of competition, including tactics and locations of competitors and operating and market competition;

Demand for our products, the quantities and qualities thereof available for sale and levels of customer satisfaction, including significant unforeseen fluctuations in global demand for products similar to our products;

Our dependence on the experience, continuity and competence of our executive officers and other key employees;

The added risks associated with or attributed to the current local, national and world economic conditions, including but not limited to, the volatility of crude oil prices, inflation and currency fluctuations;

Changes in domestic and/or foreign laws, regulations or standards, affecting nutraceutical products or our methods of operation;

Access to available and reasonable financing on a timely basis;

The Company's inability to generate enough revenues to meet its obligations or repay maturing indebtedness;

Failure of capital projects to operate as expected or meet expected results;

Changes in laws, corporate governance requirements and tax rates, regulations, accounting standards and the application to us or the nutritional products industry of new decisions by courts, regulators or other government authorities;

Legal costs associated with any legal proceedings, and the potential direct and indirect cost and other effects on our business or financial condition resulting from any legal proceedings.

Risk associated with the geographic concentration of our business;

Acts of war, terrorist incidents or natural disasters; and

Other risks or uncertainties described elsewhere in this Report and in other periodic reports previously and subsequently filed by us with the Securities and Exchange Commission.

## PART I

### Item 1. Business

Unless otherwise indicated, all references in this report to the “Company”, “we”, “us”, “our”, and “Cyanotech” refer to Cyanotech Corporation and its wholly owned subsidiary, Nutrex Hawaii, Inc. (“Nutrex Hawaii” or “Nutrex”), a Hawaii corporation.

#### General

We are a world leader in the production of high value natural products derived from microalgae. Incorporated in 1983, we are guided by the principle of providing beneficial, quality microalgal products for health and human nutrition in a sustainable, reliable and environmentally sensitive operation. We are GMP (Good Manufacturing Practices) certified by the Natural Products Association™, reinforcing our commitment to quality in our products, quality in our relationships (with our customers, suppliers, employees and the communities we live in), and quality of the environment in which we work. Our products include:

Hawaiian *BioAstin*® natural astaxanthin - a powerful dietary antioxidant shown to support and maintain the body’s natural inflammatory response, to enhance skin, and to support eye and joint health. It has expanding applications as a human nutraceutical and functional food ingredient; and

Hawaiian *Spirulina Pacifica*® - a nutrient-rich dietary supplement used for extra energy, a strengthened immune system, cardiovascular benefits and as a source of antioxidant carotenoids

Microalgae are a diverse group of microscopic plants that have a wide range of physiological and biochemical characteristics and contain, among other things, high levels of natural protein, amino acids, vitamins, pigments and enzymes. Microalgae have the following properties that make commercial production attractive: (1) microalgae grow much faster than land grown plants, often up to 100 times faster; (2) microalgae have uniform cell structures with no bark, stems, branches or leaves, permitting easier extraction of products and higher utilization of the microalgae cells; and (3) the cellular uniformity of microalgae makes it practical to control the growing environment in order to optimize a particular cell characteristic. Efficient and effective cultivation of microalgae requires consistent light, warm temperatures, low rainfall and proper chemical balance in a very nutrient-rich environment, free of environmental contaminants and unwanted organisms. This is a challenge that has motivated us to design, develop and implement proprietary production and harvesting technologies, systems and processes in order to commercially produce human nutritional products derived from microalgae.

Our production of these products at the 90-acre facility on the Kona Coast of the island of Hawaii provides several benefits. We selected the Keahole Point location in order to take advantage of relatively consistent warm temperatures, sunshine and low levels of rainfall needed for optimal cultivation of microalgae. This location also offers us access to cold deep ocean water, drawn from an offshore depth of 2,000 feet, which we use in our *Ocean-Chill Drying* system to eliminate the oxidative damage caused by standard drying techniques and as a source of trace nutrients for microalgal cultures. The area is also designated a Biosecure Zone, with tight control of organisms allowed into the area and free of genetically modified organisms (GMO's). We believe that our technology, systems, processes and favorable growing location generally permit year-round harvest of our microalgal products in a cost-effective manner.

### **Our Business**

We operate entirely in one operating segment, the cultivation and production of microalgae into high-value, high-quality natural health and nutrition products. We cultivate, on a large-scale basis, two microalgal species from which our two major product lines, natural astaxanthin products and spirulina products, are derived. We record revenue and cost of sales information by product category, but do not record operating expenses by such product category.



The following table sets forth, for the three years ended March 31, 2016, the net sales contributed by each of our product lines (in thousands):

	<b>Net Sales</b>		
	<b>2016</b>	<b>2015</b>	<b>2014</b>
Natural astaxanthin products:			
<i>BioAstin</i> ®	\$19,829	\$22,087	\$19,056
Spirulina products:			
<i>Spirulina Pacifica</i> ®	12,011	11,722	9,122
Total	\$31,840	\$33,809	\$28,178

### ***Natural Astaxanthin Products***

We commenced commercial production of natural astaxanthin in 1997 and in 1999 introduced *BioAstin*®, our natural astaxanthin product for the human health and nutrition market. *BioAstin*® represents approximately two-thirds of our net sales. Astaxanthin's antioxidant properties are believed to surpass many of the antioxidant properties of vitamin C, vitamin E, beta-carotene and other carotenoids. Independent scientific studies indicate that in certain models, natural astaxanthin has up to 550 times the antioxidant activity of vitamin E and 10 times the antioxidant activity of beta-carotene. In addition, a growing body of scientific literature suggests that natural astaxanthin has beneficial properties as an anti-inflammatory, with additional benefits for joint, skin and eye health.

*BioAstin*® is produced in two forms: a liquid lipid extract and gelcaps, both of which are sold in bulk quantities. *BioAstin*® gelcaps are also sold in packaged consumer form under the Nutrex Hawaii label as well as private label consumer packaged product. Over time, we have shifted our focus and resources on producing and marketing natural astaxanthin for the higher value packaged consumer market.

*BioAstin*® is GRAS (generally recognized as safe) as determined by the United States Food and Drug Administration. Our all natural *BioAstin*® is cultivated without the use of herbicides or pesticides, and is not genetically modified (non GMO). In fiscal 2012 we applied for a new dietary ingredient (NDI), with the United States Food and Drug Administration, providing for a daily dosage of 12mg of astaxanthin which was reviewed without comment.

We produce natural astaxanthin from *Haematococcus pluvialis* microalgae grown in fresh water supplemented with nutrients. As these algae are extremely susceptible to contamination by unwanted algae, protozoa and amoebae, we developed a proprietary system known as the *PhytoDome Closed Culture System* or *PhytoDome CCS* to overcome this problem. Using these large-scale photobioreactors, we have generally been able to grow consistently large volumes of contaminant-free *Haematococcus* culture, although quarterly production levels are subject to seasonality. Fresh water

is critical to the production of our natural astaxanthin and while we have not experienced any constraint on fresh water availability to date, availability could be impacted by a significant population growth in the region as well as throughput constraints on the water delivery infrastructure. We have met with officials of the County of Hawaii to assess the fresh water situation and evaluate the probability of future risks. We recycle fresh water in our production process where possible and continue to explore further recycling opportunities.

For the final stage of cultivation, the *Haematococcus* algae is transferred to open ponds where an environmental stress is applied causing the algae to form spores which accumulate high levels of astaxanthin. Once ready for harvest, the media containing these spores is transported through underground pipes to our astaxanthin processing building where the culture media and algal spores are separated. Fresh water recovered from this stage of processing may be recycled for further use in cultivation. Unlike spirulina, astaxanthin is produced in a batch-mode and each cultivation pond must be completely drained and thoroughly cleaned between cycles. As sunlight is a major component of cultivation, production can be impacted by inclement weather and seasonal changes during the winter months, with shorter daylight hours and increased cloud cover.

The harvested algal spores are dried to flakes or a fine powder. During processing, the spores are cracked in a proprietary system to assure high bioavailability of astaxanthin. Each production lot of astaxanthin is sampled and tested for astaxanthin concentration. Finally, the bulk powder is vacuum-packed. Natural astaxanthin for human consumption is processed further utilizing a high-pressure extraction process. The resulting product is a lipid extract insoluble in water used in the production of gelcaps.

All natural astaxanthin products undergo a prescribed set of microbiological food product tests to ensure safety and quality. We have historically used third party contract manufacturers for the extraction services and the production of gelcaps. However, beginning June 2015 we have the capability to perform the extraction process at our new extraction and warehouse facility in Kona, Hawaii. All third party contract manufacturers are audit inspected by our Quality Control Department and are required to comply with the Food and Drug Administration (FDA) Good Manufacturing Practices (GMP) regulations. The majority of these contract manufacturers hold independent third party GMP certifications.

*BioAstin*® is sold in liquid lipid form as a raw ingredient to dietary supplement manufacturers, health food formulators and cosmetic manufacturers, and *BioAstin*® gelcaps are sold in bulk quantities to distributors. *BioAstin*® gelcaps are also sold as a packaged consumer product through Nutrex Hawaii directly to natural product distributors, retailers and consumers. In 2007, we also introduced a line of *BioAstin*® based nutritional supplements, *MDFormulas*. *MDFormulas* combined the health benefits of *BioAstin*® with other proven nutrients with benefits for targeted applications such as skin, heart and joint health.

*BioAstin*® competes directly with similar products marketed by other manufacturers including Fuji Chemical of Japan, Algatechnologies of Israel, BGG of China and Valensa (dba U.S. Nutraceuticals, LLC) in the United States. In the general category of nutritional supplements, *BioAstin*® and *MDFormulas* also compete with a variety of vitamins, dietary supplements and other antioxidant products available to consumers. The nutritional products market is highly competitive and includes international, national, regional and local producers and distributors, many of whom have greater resources than we have, and many of whom offer a greater variety of products.

The potential benefits of astaxanthin to human health are continuing to emerge. As one of the most potent and bioactive biological antioxidants found in nature, the number of potential roles of natural astaxanthin for human health is growing. Much research has been published in recent years on the beneficial roles of antioxidants in our health, in the aging process and on specific health conditions. The full efficacy of *BioAstin*® as a human nutraceutical supplement requires further significant clinical study. We have spent limited amounts on clinical trials over the past few fiscal years. Independent antioxidant research and prior clinical trials show promising human applications. We hold three United States patents relating to the usage of *BioAstin*® in the treatment of Carpal Tunnel Syndrome, the treatment of canker/cold sores and for its use as a topical and oral sunscreen.

### ***Spirulina Products***

We have been producing a strain of spirulina microalgae marketed as Hawaiian *Spirulina Pacifica*® since 1984. *Spirulina Pacifica*® represents approximately one-third of our net sales. *Spirulina Pacifica*® provides a vegetable-based, highly absorbable source of protein, natural beta-carotene, mixed carotenoids, B vitamins, gamma linolenic acid, essential amino acids and other phytonutrients.

*Spirulina Pacifica*® is produced in two forms: powder and tablets. Powder is used as an ingredient in nutritional supplements and health beverages; tablets are consumed as a daily dietary supplement. Both forms are sold as raw material ingredients in bulk quantities, as packaged consumer products under the Nutrex Hawaii label and as private label consumer packaged products. We recently launched two new spirulina products. Spearmint spirulina tablets provide a fresh, new flavor option for both current consumers and those trying spirulina for the first time, and Greens Complete Superfood Powder formula is our entry into the green superfood category, each serving is packed with three grams of spirulina plus organic greens, organic antioxidants and probiotics.

*Spirulina Pacifica*® is GRAS (generally recognized as safe) for addition to a variety of foods as determined by the United States Food and Drug Administration. Our all natural *Spirulina Pacifica*® is cultivated without the use of herbicides or pesticides, is not genetically modified (non GMO) and is certified Kosher by Organized Kashrus Laboratories of Brooklyn, New York and certified Halal by the Islamic Food and Nutrition Council of America.

Our *Spirulina Pacifica*® is cultivated in a combination of fresh water and a metered amount of nutrient-rich deep ocean water (containing essential trace elements), drawn from a depth of 2,000 feet below sea level. This water mixture is supplemented with other major required nutrients. With the exception of deep ocean water, the raw materials and nutrients required in our spirulina production are available from multiple sources. In the case of deep ocean water, although abundantly available at this location, the facility to pump and deliver the water to our location is owned by the State of Hawaii. The facility is constructed of two separately located pump stations providing redundancy should one station fail. The State of Hawaii sets the price for deep ocean water annually based on its cost to deliver the water.

The spirulina crop in each pond is circulated by paddlewheels to keep an even blend of nutrients in suspension and a uniform exposure of the algae to sunlight. Our ponds are engineered to maintain the right media depth for sunlight to permeate each crop completely, facilitating rapid growth. The design of our cultivation ponds promotes efficient growing conditions, allowing the *Spirulina Pacifica*® algae to reproduce rapidly. Each pond can be harvested, on average, in six days. As sunlight is a major component of cultivation, production can be impacted by inclement weather and seasonal changes during the winter months, with shortened daylight hours.

Once ready for harvest, a majority of the spirulina algae are pumped from a pond to our processing building where the crop is separated from the culture media. The culture remaining in the ponds serves as an inoculum for the next growth cycle. Harvested spirulina is washed with fresh water and filtered before moving to the drying stage. Culture media separated from spirulina algae during processing are conserved and recycled. Our *Integrated Culture Biology Management* (“ICBM”) technology for microalgae cultivation has proven to be a reliable and stable operating environment, allowing us to grow and harvest spirulina without significant contamination by unwanted microorganisms and without associated loss of productivity.

*Spirulina Pacifica*® powder is dried via our low-oxygen *Ocean-Chill Drying* process, thereby preserving high levels of antioxidant carotenoids and other nutrients sensitive to heat and oxygen. The rapid drying process results in a dark green powder. Spirulina powder is difficult to form into tablets. Most tablet manufacturers either add high amounts (from 10% to 30%) of inert substances to “glue” the tablet together or use a heat granulation process that destroys nutrients. In contrast, our *Spirulina Pacifica*® tablets contain a maximum of 2% of such substances and are produced in cold press compression tablet-making machines.

Each production lot of *Spirulina Pacifica*® is sampled and subjected to thorough quality control analyses including testing for moisture, carotenoids, minerals, color and taste, among others. Further, each lot of our *Spirulina Pacifica*® undergoes a prescribed set of microbiological food product tests, including total aerobic bacteria, coliform bacteria and E. coli. The *Spirulina Pacifica*® powder and tablets are packaged to extend shelf life and ensure product freshness. Our packaged consumer products are bottled and labeled by third party contractors in California. These contractors are subject to regular government inspections and hold Drug Manufacturing Licenses & Processed Food Registrations with the State of California Department of Health. Such packaging services are readily available from multiple sources.

The majority of our bulk spirulina is sold to international health food manufacturers and formulators, many of whom identify and promote our Hawaiian *Spirulina Pacifica*® in their products. Such customers purchase bulk powder or bulk tablets and package these products under their brand label for sale to the health and natural food markets in their countries. Some of the brands produced by these customers are marketed and sold in direct competition with the packaged consumer products sold through our Nutrex Hawaii subsidiary in international channels. In the domestic market, Nutrex Hawaii packaged consumer products are sold through an established health food distribution network or directly to consumers. In selected international markets, we have exclusive sales distributors for both our bulk and packaged consumer products.

Our *Spirulina Pacifica*® products compete with a variety of vitamins, dietary supplements, other algal products and similar nutritional products available to consumers. The nutritional products category is highly competitive and includes international, national, regional and local producers and distributors, many of whom have greater resources than Cyanotech and many of whom offer a greater variety of products. Our direct competition in the spirulina market is currently from Dainippon Ink and Chemical Company's Earthrise facility in California, Parry Nutraceuticals, a division of Murugappa Group of India and several farms in China. In addition, there are numerous other smaller farms throughout the world. We have experienced increased price competition due to the large number of spirulina suppliers as well as customers who generally treat these products as commodities with price being the major determining factor driving their purchasing decision. As one of the largest producers of spirulina, our challenge is to increase our market share among customers who seek the high-quality products we produce while concurrently adjusting our product mix to meet our revenue and profitability targets.

### **Major Customers**

Two customers accounted for 19% and 11%, respectively, of our total net sales in the fiscal year ended March 31, 2016. One customer accounted for 13% of our total net sales in the fiscal year ended March 31, 2015. There were no customers with sales at or above 10% of our total net sales for the year ended March 31, 2014.

### **Research and Development**

Our expertise for many years has been in the development of efficient, stable and cost-effective production systems for microalgal products. We have learned production levels from our systems may not be sustainable across periods of days, weeks, or even months. Accordingly, we typically investigate each specific microalgae identified in the scientific literature for potentially marketable products and for solutions to production stability and efficiency challenges, and then strive to develop the technology to grow such microalgae on a commercial scale or to incorporate procedures or technology to improve production stability and efficiency. Successful microalgal product developments and technical solutions are highly uncertain and dependent on numerous factors, many beyond our control. Products and solutions or improvements that appear promising in early phases of development may be found to be ineffective, may be uneconomical because of manufacturing costs or other factors, may be precluded from commercialization due to the proprietary rights of other companies, or may fail to receive necessary regulatory approvals. We had research and development expenditures of \$633,000, \$517,000 and \$469,000 in fiscal years 2016, 2015 and 2014, respectively. We invested \$80,000, \$6,000 and \$69,000 in scientific clinical trials during fiscal 2016, 2015 and 2014, respectively.

## Patents, Trademarks and Licenses

We have been granted four United States patents: one on aspects of our production methods and three relating to usage of our *BioAstin*® products.

Our production method patent is directed to microalgae production technology, and expired in April 2016. Our patents relating to usage of our *BioAstin*® products are three utility patents on the use of astaxanthin, which will expire in December 2019, February 2020 and April 2020.

Although we view our proprietary rights as important, we currently believe that a loss of patent rights is not likely to have a material adverse effect on our present business as a whole. Instead, our commercial results mainly depend upon our trade secrets, know-how, other non-patent proprietary rights, customer relationships, our climate and our location. As a result, we feel that our competitors in the U.S. would not be able to implement competing technology covered by our patents now, after their expirations or otherwise, without our same combination of non-patented attributes.

We have registered trademarks in the U.S. and in some foreign markets, such as the European Union. Our operations are not dependent upon any single trademark, although some trademarks are identified with a number of our products and are important in the sale and marketing of such products.

## Regulations

Several governmental agencies regulate various aspects of our business and our products in the United States, including the Food and Drug Administration, the Federal Trade Commission, the Consumer Product Safety Commission, the State of Hawaii Department of Health, the Department of Agriculture, the Environmental Protection Agency, the United States Postal Service, state attorney general offices and various agencies of the states and localities in which our products are sold. We believe we are in compliance the all material government regulations which apply to our products and operations. However, we are not able to predict the nature of any future laws, regulations, interpretations or applications, nor can we predict what effect future changes would have on our business.

Our international customers are subject to similar governmental agency regulations in their various geographic regions. Compliance by our customers with such local regulations is beyond our control and we cannot predict their ability to maintain such compliance. However, we strive to assist our customers in meeting local regulations pertaining to the use and sale of our products whenever possible.

## Environmental Matters

In 2002, we were issued under the Endangered Species Act (“ESA”) an Incidental Take Permit (“ITP”) by the United States Department of Interior Fish and Wildlife Service (“FWS”). The ESA defines “incidental take” as “incidental to, and not for the purpose of, the carrying out of an otherwise lawful activity.” This permit authorizes incidental take of the endangered Hawaiian stilt (*Himantopus mexicanus knudseni*) that is anticipated to occur as a result of ongoing operations and maintenance at our Kona facility. As a mandatory component for the issuance of such permit, we submitted and maintain a Habitat Conservation Plan (“HCP”) to ensure that the effects of the permitted action on listed species are adequately minimized and mitigated.

The HCP called for the creation of a nesting and breeding ground for the Hawaiian stilt to offset any take activity. We have complied with these requirements since 2002. The breeding program was so successful that the increase in the Hawaiian stilt population in the area became a potential hazard for the adjacent State airport facility. We disassembled the stilt habitat and are mitigating “take” by using standard non-lethal hazing devices to discourage nesting and breeding.

A requirement of the ITP is to provide insurance coverage for funding the project for the term of the ITP. Our insurance broker was unable to locate an underwriter who would provide such a bond. As permitted by law, the FWS waived this requirement recognizing that this HCP did not involve a significant capital expenditure. However, under Hawaii state law, no waiver provision is available. A new ITP was issued by the FWS on September 29, 2006 and by the State of Hawaii Division of Forestry and Wildlife (DOFAW) on October 13, 2006, both of which expired on March 17, 2016.



On March 14, 2016 the Company submitted an application for “Amendment and Extension to Cyanotech Corporation’s Habitat Conservation Plan and Incidental Take Permit” to FWS and DOFAW. The term of the requested extension is 19 years ending in 2035. The application is under review by the Federal and State Agencies and has not yet been granted. While we do not anticipate any significant problems in receiving the requested amendment and extension to the Company’s HCP/ITP because we have satisfied all conditions of past HCP’s/ITP’s and our operation is considered by the State of Hawaii as “low effect”, there can be no guarantees we will not encounter delays in receiving the requested amendment or that FWS and/or DOFAW will not impose additional requirements on us in connection with granting the requested amendment, which may impose additional costs on us .

## **Employees**

As of March 31, 2016, we employed 123 people on a full-time basis. Of the total, 58 are involved in harvesting, production and quality, with the remainder in maintenance, shipping, sales, administration and support. None of our employees are subject to collective bargaining agreements. Management believes that its relations with employees are good.

## **Company Website and SEC Filings**

Our corporate website is *www.cyanotech.com*. There we make available copies of Cyanotech documents, news releases and our filings with the Securities Exchange Commission, or the “SEC”, including financial statements. Also included are copies of the Board of Directors Code of Conduct, the Company’s Code of Conduct and Ethics, the Nominating and Corporate Governance Committee Charter, the Compensation Committee Charter and the Charter and Powers of the Audit Committee. We also maintain the website *www.nutrex-hawaii.com* dedicated to our wholly owned subsidiary, Nutrex Hawaii, Inc. On that website, *Spirulina Pacifica*® and *BioAstin*® are sold directly online. The information found on our websites, unless otherwise indicated, is not part of this or any other report we file or furnish to the Securities and Exchange Commission.

## **Item 1A. Risk Factors**

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

**Our production of algae involves an agricultural process, subject to such risks as weather, disease and contamination.**

The production of our algae products involves complex agricultural systems with inherent risks including weather, disease, and contamination. These risks are unpredictable and also include such elements as the control and balance of necessary nutrients and other factors. The efficient and effective cultivation of microalgae requires consistent light, warm temperatures, low rainfall and proper chemical balance in a very nutrient-rich environment. If the chemical composition of a pond changes from its required balance, unusually high levels of contamination due to the growth of unwanted organisms or other biological problems may occur and would result in a loss of harvestable output. These often arise without warning and sometimes there are few or no clear indicators as to appropriate remediation or corrective measures. We believe that our technology, systems, processes and favorable growing location generally permit year-round harvest of our microalgal products in a cost-effective manner. However, environmental factors cannot be controlled in an open air environment, therefore, we cannot, and do not attempt to, provide any form of assurance with regard to our systems, processes, location, or cost-effectiveness. To the extent that our production is negatively impacted by environmental factors, we may be unable to fill large orders for one or more months until such time that production improves.

**There is risk in operating entirely in one business segment such as the cultivation and production of microalgae at a single production facility.**

Single location agricultural and production facilities do not provide the protections and assurances afforded by operations in two or more widely separated locations. Our single location in Hawaii is susceptible to catastrophic natural disasters such as earthquakes, tsunamis, hurricanes and volcanic eruptions. In the event of a natural disaster or localized extended outages of critical utilities or transportation systems, we could experience a significant business interruption. In addition, Hawaii from time to time has experienced shortages of water, electric power and fuels. Future shortages could disrupt our operations and could result in additional expense. Also, a single agricultural facility provides limited biologic diversity protection against invasive, mutant, or harmful organisms.

**Our facilities in Hawaii are located adjacent to a major airport, and an aircraft disaster could disrupt our operations.**

Our production facility and corporate headquarters in Hawaii are located adjacent to the Keahole International airport. In the event of an aircraft disaster, we could experience a significant business interruption, including loss of water, electrical and communication services as well as inability to access our facilities.

**Unfavorable publicity or consumer perception of our products and any similar products distributed by other companies could have a material adverse effect on our business.**

The nutritional supplements market is highly dependent upon consumer perception regarding the safety, efficacy and quality of nutritional supplements. Consumer perception of our products can be significantly influenced by scientific research and findings, as well as by national media attention and other publicity regarding the consumption of nutritional supplements. There can be no assurance that future research or publicity will be favorable to the nutritional supplements market or any product in particular, or consistent with earlier publicity. Our dependence on consumer perception means that any adverse reports, findings or publicity, whether or not accurate or with merit, could have a material adverse effect on the demand for our products and on our results of operations, cash flow and financial condition.

**We may become subject to legal proceedings.**

We may become subject claims and legal proceedings in the ordinary course of business. The costs of such proceedings could vary from quarter to quarter based on the status of the proceedings and could have a material impact on our results in any given quarter.

**The nutritional products industry is extremely competitive. Many of our significant competitors have greater financial and other resources than we do, and one or more of these competitors could use their greater resources to gain market share at our expense.**

The nutritional products market includes international, national, regional and local producers and distributors, many of whom have substantially greater production, financial, research and development, personnel and marketing resources than we do, and many of whom offer a greater variety of products. As a result, each of these companies could compete more aggressively and sustain that competition over a longer period of time than we could. Our lack of resources relative to our significant competitors may cause us to fail to anticipate or respond adequately to development of new

products and changing consumer demands and preferences, or may cause us to experience significant delays in obtaining or introducing new or enhanced products. These failures or delays could reduce our competitiveness and cause a decline in our market share and sales. Increased competition in our industry could result in price reductions, reduced gross profit margin or loss of market share, any of which could have a material effect on our business, results of operations and financial condition.

**We depend heavily on the unique abilities and knowledge of our officers and key personnel. If we are unable to recruit and retain key personnel, we may be unable to achieve our goals.**

Our success depends, to a significant extent, upon the services of key personnel. For example, our interim Chief Executive Officer (who is also our founder and former Chief Scientific Officer) is our primary scientific resource, continuing to improve production and cultivation technology and to investigate new microalgal products. Our Chief Financial Officer has a unique understanding of our financial systems and needs. Our Vice President Operations has years of experience with the mechanical operation of the production facility and continues to improve our production process. Our Vice President Sales and Marketing has developed valuable personal relationships with domestic and foreign customers. Our Vice President of Quality and Regulatory Affairs has experience and knowledge of federal and state regulations governing our production processes and product representation essential to continuing compliance. The loss of any such personnel or the delay in the replacement of such personnel could significantly delay the achievement of our business objectives and could adversely affect our ability to do business or provide needed management. We are also in the process of searching for a permanent Chief Executive Officer. Attracting permanent skilled executives in Hawaii can be difficult due to limited local qualified applicants. If we are unable to attract qualified candidates, or if the search process takes longer than expected, it could adversely impact our business.

**Our operations are vulnerable because we have limited personnel and redundancy and backup systems in our data management function.**

Our internal order, inventory and product data management system is an electronic system through which orders are placed for our products and through which we manage product pricing, shipment, returns and other matters. This system's continued and uninterrupted performance is critical to our day-to-day business operations. Despite our precautions, unanticipated interruptions in our computer and telecommunications systems have, in the past, caused problems or stoppages in this electronic system. These interruptions, and resulting problems, could occur again in the future. We also have limited personnel available to process purchase orders and to manage product pricing and other matters in any manner other than through this electronic system. Any significant interruption or delay in the operation of this electronic management system could cause a decline in our sales and profitability.

**The loss of a major customer could result in a material reduction in our revenues and profitability.**

Our top ten customers generated 58% and 55% of our net sales during fiscal 2016 and fiscal 2015, respectively. Accordingly, the loss of one or more of those customers or a substantial decrease in such customers' purchases from us could result in a material reduction in our revenues and profitability.

**Compliance with new and existing governmental regulations could increase our costs significantly and adversely affect our results of operations.**

The processing, formulation, manufacturing, packaging, labeling, advertising and distribution of our products are subject to federal laws and regulation by one or more federal agencies, including the FDA, the FTC, the USDA and the EPA. These activities are also regulated by various state, local and international laws and agencies of the states and localities in which our products are sold. Regulations may prevent or delay the introduction, or require the reformulation, of our products, which could result in lost sales and increased costs to us. A regulatory agency may not accept the evidence of safety for any new ingredients that we may want to market, may determine that a particular product or product ingredient presents an unacceptable health risk, may determine that a particular statement of nutritional support on our products or that parties use on the products we manufacture for them, or that we want to use on our products or that third parties want to use on the products we manufacture for them, is an unacceptable drug claim or an unauthorized version of a food "health claim". A regulatory agency may determine that particular claims are not adequately supported by available scientific evidence. Any such regulatory determination would prevent us from marketing particular products or using certain statements on those products, which could adversely affect our sales of those products.

Additional or more stringent laws and regulations of dietary supplements and other products have been considered from time to time. These developments could require reformulation of some products to meet new standards, recalls or discontinuance of some products not able to be reformulated, additional record-keeping requirements, increased documentation of the properties of some products, additional or different labeling, additional scientific substantiation, or other new requirements. Any of these developments could increase our costs significantly. In addition, regulators' evolving interpretation of existing laws could have similar effects.

**A significant or prolonged economic downturn could have a material adverse effect on our results of operations.**

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

The global cost of oil derived energy impacts us in several ways, and it may hinder our efforts to achieve profitability. Oil prices primarily impact us through the costs of electricity, transportation, materials and supplies which are tied to the cost of oil either directly or indirectly. The return of a high cost of oil on a global basis may signal a prolonged economic downturn resulting in a material adverse effect on our business.

**Our quarterly operating results may vary from quarter to quarter, which may result in increased volatility of our share price.**

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

weather-related cultivation difficulties;

any non-routine legal fees;

fluctuations in customer demand;

business decisions of our customers regarding orders for our products;

changes in energy costs;

changes in raw material costs;

production problems which we cannot solve technically or economically;

contamination of our cultivation and production facilities;

effects of weather on our ability to meet customer demand;

timing of promotional activities;

the introduction of new products by us or our competitors;

changes in our pricing policies or those of our competitors;

changes in seasonal and other trends in our customers' buying patterns;

changes in government regulation, both domestic and foreign;

fluctuation in foreign currency exchange rates;

global economic and political conditions and related risks, including acts of terrorism; and

other factors beyond our control.

A significant portion of our expense levels are relatively fixed. If net sales are below expectations in any given period, the adverse impact on results of operations may be magnified by our inability to reduce expenses quickly enough to compensate for the sales shortfall.

**Our global operations expose us to complex management, foreign currency, legal, tax and economic risks, which we may not be able to address quickly and adequately.**

Our products are marketed in a number of countries around the world. For the year ended March 31, 2016, approximately 29% of our net sales were from sales to foreign customers. As a result, we are subject to a number of risks which include, but are not limited to:

the burden of complying with a wide variety of national and local laws;

potentially longer payment cycles for foreign sales;

restrictions (government and otherwise) on the movement of cash;

the absence in some jurisdictions of effective laws protecting our intellectual and proprietary property rights, or of enforcement of such laws where they do exist;

changes in government regulations, both domestic and foreign;

global economic and political conditions and related risks, including acts of terrorism; and

fluctuations in foreign currency exchange rates.

**If we are unable to protect our intellectual property rights or if we infringe upon the intellectual property rights of others our business may be harmed.**

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



**Our insurance liability coverage is limited and may not be adequate to cover potential losses.**

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

**Our ability to develop and market new products or modify existing products and production methods may be adversely affected if we lose the services of or cannot replace certain employees knowledgeable in advanced scientific and other fields.**

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

**We may need to raise additional capital in the future which may not be available.**

We believe our cash and cash equivalents to be provided from operations will be sufficient to meet our working capital and operating requirements for at least the next 12 months, but we may need to raise additional funds and we may not be able to secure funding on acceptable terms, if at all. If we raise additional funds through the issuance of equity or convertible debt securities, the percentage ownership of our then current stockholders may be reduced. If we raise additional funds through the issuance of convertible debt securities, or through additional debt or similar instruments, such securities, debt, or similar instruments could have rights senior to those of our common stockholders and such instruments could contain provisions restricting our operations. If adequate funds are not available to satisfy

either short-term or long-term capital requirements, we may be required to limit operations with adverse results.

**We have incurred significant losses in the past. If we incur significant losses in the future, we will experience negative cash flow which may hamper current operations and prevent us from sustaining or expanding our business.**

As of March 31, 2016, we had an accumulated deficit of approximately \$13.9 million, primarily as a result of significant losses incurred during fiscal years ended March 31, 2016, 2008 and 2007 of \$4.4 million, \$1.1 million and \$7.4 million, respectively. The 2007 loss included a non-cash impairment loss on equipment and leasehold improvements of \$4.5 million. These account for approximately 90% of our accumulated deficit since our inception. Historically, we have relied upon cash from operations and financing activities to fund all of the cash requirements of our business. However, extended periods of net income do not assure positive cash flows. Future periods of net losses from operations could result in negative cash flow, and may hamper ongoing operations and prevent us from sustaining or expanding our business. We cannot assure you that we will sustain or increase profitability on a quarterly or annual basis in the future. If we do not achieve, sustain or increase profitability, our business will be adversely affected and our stock price may decline.

**Our stock price is volatile, which could result in substantial losses for investors purchasing shares of our common stock.**

Stock markets have experienced extreme volatility that has often been unrelated to the operating performance of particular companies. These broad market fluctuations may adversely affect the trading price of our common stock. In addition, the average daily trading volume of the securities of small companies can be very low. Limited trading volume of our stock may contribute to its future volatility. Price declines in our common stock could result from general market and economic conditions and a variety of other factors, including any of the following:

volatility resulting from minimal trading activity;

changes in market valuations of similar companies;

stock market price and volume fluctuations generally;

economic conditions specific to the nutritional products industry;

economic conditions tied to global resource markets, such as fuel costs;

announcements by us or our competitors of new or enhanced products or of significant contracts, acquisitions, strategic relationships, joint ventures or capital commitments;

fluctuations in our quarterly or annual operating results;

changes in our pricing policies or the pricing policies of our competitors;

changes in foreign currency exchange rates affecting our product costs, pricing or our customers markets;

regulatory developments effecting our specific products or industry; and

additions or departures of key personnel.

The price at which you purchase shares of our common stock may not be indicative of the price that will prevail later in the trading market. You may be unable to sell your shares of common stock at or above your purchase price, which may result in substantial losses to you. As of March 31, 2016, there were approximately 5.6 million shares of our common stock outstanding and stockholders holding at least 5% of our stock, individually or with affiliated persons or entities, collectively beneficially owned or controlled approximately 46% of such shares. Sales of large numbers of shares by any of our large stockholders could adversely affect our trading price, particularly given our relatively small historic trading volumes. If stockholders holding shares of our common stock sell, indicate an intention to sell, or if it is perceived that they will sell, substantial amounts of their common stock in the public market, the trading price of our common stock could decline. Moreover, if there is no active trading market or if the volume of trading is limited, holders of our common stock may have difficulty selling their shares.

**Recent European Union regulations include stringent requirements for health claims on food and supplement labels.**

The European Union has harmonized standards among Member States for health claims on food and supplement labels. The scientific assessment of health claims is performed by the European Food Safety Authority (EFSA), an

advisory panel to the European Commission. The European Commission will consider the opinions of EFSA in determining whether to include a health claim on a Positive List of permissible claims. Once the list is published, only health claims for ingredients and products included on the list may be used in promotional materials for products marketed and sold in the European Union. This could severely decrease or limit the marketability for our products in this market area. We have implemented strategies that we believe will allow for continued and increasing sales of our products in the European Union. However there can be no guarantee that such strategies will be successful.

## **Item 2. Properties**

Our principal facility and corporate headquarters is located at the Natural Energy Laboratory of Hawaii Authority (“NELHA”) at Keahole Point in Kailua-Kona, Hawaii. It encompasses approximately 90 fully developed acres containing microalgal cultivation ponds, processing facilities, research and quality control laboratories, and sales and administrative offices. The property is leased from the State of Hawaii under a 40-year commercial lease expiring in 2035. Our lessee interest in the NELHA lease is encumbered by a mortgage securing approximately \$7.4 million of debt (see footnote 5 of the financial statements). If we were to require additional land for expansion, we believe that there is sufficient available land at NELHA, provided a revised NELHA lease can be negotiated with acceptable terms. Under the terms of the existing NELHA lease, we could be required to remove improvements at the end of the lease term. Based upon our analysis, we do not believe the projected cost for such removal to be reasonably estimable, or likely, given historical practices. However, conditions could change in the future. It is not possible to predict such changes or estimate any impact thereof. We also rent warehouse space near NELHA and in Ontario, California, and office space in Los Angeles, California.

### Item 3. Legal Proceedings

From time to time the Company may become party to lawsuits and claims that arise in the ordinary course of business relating to employment, intellectual property, and other matters. There were no significant legal matters outstanding at March 31, 2016.

On May 24, 2016, one of our shareholders, Meridian OHC Partners, LP, filed a complaint in the United States District Court, District of Nevada, entitled *Meridian OHC Partners, LP vs. Cyanotech Corporation, Michael Davis and Rudolf Steiner Foundation (RSF), Inc.* The complaint makes certain derivative claims on behalf of the Company, direct claims on behalf of Meridian, and alleges, among other things, (i) that there were deficiencies in the beneficial ownership reports of Mr. Davis, the Chairman of our Board of Directors, and RSF, one of our shareholders, including that Mr. Davis and RSF are an undisclosed group with respect to their shares of Company Common Stock, (ii) that Mr. Davis has failed to disclose control over his full voting power of the Company's Common Stock in order to avoid triggering the State of Nevada's "Acquisition of Controlling Interest" statutes, and (iii) that Mr. Davis has breached fiduciary duties to the Company. Meridian seeks declaratory and injunctive relief to reform this conduct, requests that the court award the Company the damages allegedly sustained as a result of the conduct, seeks relief directly against Mr. Davis and RSF and seeks other relief.

The Board of Directors of the Company has formed a Special Committee comprised of independent directors to investigate, review and analyze the Meridian allegations and provide its recommendations to the Board.

**PART II****Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities**

Our common stock is listed and traded on the NASDAQ Capital Market under the symbol "CYAN". The closing price of our common stock was \$4.90 as of June 20, 2016. The approximate number of holders of record of our common stock was 1,000 as of June 20, 2016. The high and low selling prices as reported by NASDAQ were as follows:

<b>Quarter Ended:</b>	<b>June 30</b>	<b>September 30</b>	<b>December 31</b>	<b>March 31</b>
Fiscal 2016				
Common stock price per share:				
High	\$10.25	\$ 9.63	\$ 6.08	\$ 5.41
Low	\$8.75	\$ 5.73	\$ 5.10	\$ 3.89
Fiscal 2015				
Common stock price per share:				
High	\$5.46	\$ 4.88	\$ 7.84	\$ 9.00
Low	\$4.41	\$ 4.45	\$ 4.51	\$ 6.10

We are prohibited from declaring any common stock dividends without the prior written consent of a lender per the conditions of an existing term loan agreement with such lender. We have never declared or paid cash dividends on our common stock. We currently do not anticipate paying any cash dividends on common stock.

The following table sets forth the Company's common shares authorized for issuance under equity compensation plans:

<b>Common shares to be issued upon exercise of options outstanding (in</b>	<b>Weighted- average exercise price of outstanding options</b>	<b>Common shares available for future grant under equity compensation plans</b>
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	<b>shares)</b>		<b>(in shares)</b>
Equity compensation, plans approved by security holders	685,000	\$ 4.65	314,241

**Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations**

Management’s Discussion and Analysis of Financial Condition and Results of Operations (“MD&A”) is intended to provide a reader of our financial statements with a narrative of our financial condition, results of operations, liquidity and certain other factors that may affect our future results from the perspective of management.

*Our MD&A should be read in conjunction with the consolidated financial statements and notes thereto appearing elsewhere in this Form 10-K. A more comprehensive description of our products and markets for such products is provided in Part I. Item 1. Business.*

**Overview**

We are a world leader in the production of natural products derived from microalgae, with a core competency in cultivating and processing microalgae into high-value, high-quality natural products for the human nutrition market. We produce our algae in Hawaii and manufacture the finished products in Hawaii and California. Our products are marketed worldwide and are sold in bulk quantities to manufacturers, formulators and distributors in the health foods and nutritional supplements markets and as packaged consumer products to distributors, retailers and direct consumers. We generated 29%, 29% and 38% of our revenues outside of the United States during the years ended March 31, 2016, 2015 and 2014, respectively. Competing in a global marketplace, we are influenced by the general economic conditions of the countries in which our customers operate, including adherence to our customers’ local governmental regulations and requirements. Since all sales are made in U.S. currency, we have no material foreign exchange exposure.

Our production levels have a significant impact on our gross profit margin, as well as our ability to meet customer demand. Because our processes are agricultural, it is important to maintain production volumes in order to support the minimal resource levels required to sustain a large-scale open culture agricultural facility. Our production costs include customary variables such as availability and costs of personnel, raw materials, energy, water and freight. These variables fluctuate based on changes in the local, national and world economies. More complex variables include cultivation methods, feeding formulations and harvesting processes, all of which include efforts to anticipate the extent of weather and environmental events and make timely and sufficient adjustments. Although the variability of such costs cannot be fully anticipated, we have focused increased effort in this area in order to produce both spirulina and astaxanthin at levels sufficient to fully absorb production costs into inventory.

Fresh water is critical for our natural astaxanthin production and, while we have not experienced any constraint on fresh water availability, future availability could be negatively impacted by significant growth in the local population as well as by throughput constraints on the water delivery infrastructure owned by the County of Hawaii. Given the criticality of fresh water to our operations and the community, we recycle fresh water where possible and have developed additional water recycling systems in our efforts to utilize fresh water efficiently. Both fresh and sea water require electricity for pumping; and electricity, our single largest expenditure, depends on the cost of fuel which is, in turn, tied to the global price of crude oil.

In our discussion of operating results, we refer to abnormal costs. Complex biological processes in the cultivation and processing of our microalgae are influenced by factors beyond our control—the weather, for example. As a result, we cannot assure that adequate production levels will be consistent period over period. To the extent that our production levels are not sufficient to absorb these costs on a period basis, we recognize abnormal production costs, including fixed cost variances from normal production capacity, as an expense in the period incurred. Abnormal amounts of freight, handling costs and wasted material (spoilage) are recognized as current-period charges and fixed production overhead costs are allocated to inventory based on the normal capacity of production facilities. Normal capacity is defined as “the production expected to be achieved over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance.” To offset increased production costs, we seek ways to increase production efficiencies in volume yield, potency, and quality consistent with our commitment to produce high-value, high-quality products.

We utilize several third-party contractors for encapsulation of our gelscaps and for the packaging of our finished Nutrex Hawaii products. Although these services are available from a limited number of sources, we believe that we have the ability to use other parties if any of the current contractors become unavailable.

In fiscal 2016, we completed a \$2.5 million capacity expansion that includes new ponds and related infrastructure, as well as systems designed to protect the algae from environmental factors during its growth cycle.



Also in fiscal 2016, we commissioned the supercritical carbon dioxide extraction equipment that we purchased from ThyssenKrupp Industrial Solutions (USA), Inc. (“TKIS”), formerly Uhde Corporation of America, in an agreement dated September 12, 2012. We are now able to perform the process of extraction for our natural astaxanthin biomass in our new production and warehouse facility at our Kona, Hawaii location, from which we expect to benefit from cost savings and cycle time reduction.

**Fiscal 2016 summary:**

Net sales for the year were \$31.8 million, a decrease of \$2.0 million or 6% from the prior year, driven primarily by a 31% decrease in sales of bulk products, offset by a 4% increase in sales of our consumer products. Additionally, changes in our customer mix in the first three quarters of the year resulted in higher sales allowances on sales of packaged product, which negatively impacted revenue and gross profit by \$0.9 million.

Fiscal 2016 pretax loss was \$1.1 million compared to pretax income of \$0.2 million in fiscal 2015. In addition to the \$2.0 million reduction in sales, the decrease in pretax income was also driven by start-up costs on our extraction facility (\$0.4 million), costs related to the Company’s separation with its former CEO as of March 31, 2016 (\$0.6 million), and higher audit fees as a result of the delayed filing of our fiscal 2015 Annual Report on Form 10-K (\$0.2 million).

In fiscal 2016, we recorded a valuation allowance of \$3.6 million against our deferred tax assets, resulting in a net loss for the year of \$4.4 million compared to a net loss of \$0.02 million in fiscal 2015. While our long-term outlook remains positive, we felt that a valuation allowance was appropriate in light of our recent losses.

Cash from operating activities was \$0.7 million, a decrease of \$0.5 million from the prior year. The decrease was driven by a \$2.1 million increase in inventories to replenish depleted safety stock levels, offset by a \$1.3 million increase in accounts payable and accrued expenses. Cash and cash equivalents at March 31, 2016 decreased \$1.0 million compared to last year due to the increased inventory levels and investments in capital expenditures offset by proceeds from financing. Working capital decreased 13% to \$6.5 million at March 31, 2016 from \$7.5 million a year ago, mainly due to the reduction in cash.

### Results of Operations for the 2016, 2015 and 2014 Fiscal Years

The following tables present selected consolidated financial data for each of the past three fiscal years (\$ in thousands):

<b>Consolidated Performance Summary</b>	<b>2016</b>	<b>2015</b>	<b>2014</b>
Net sales	\$31,840	\$33,809	\$28,178
Net sales increase	(5.8 )%	20.0 %	2.6 %
Gross profit	\$11,866	\$14,466	\$11,189
Gross profit as % of net sales	37.3 %	42.8 %	39.7 %
Operating expenses	\$12,651	\$14,144	\$11,399
Operating expenses as % of net sales	39.7 %	41.8 %	40.5 %
Operating (loss) income	\$(785 )	\$322	\$(210 )
Operating (loss) income as % of net sales	(2.5 )%	1.0 %	(0.7 )%
Income tax expense	\$(3,328 )	\$(253 )	\$(92 )
Net loss	\$(4,395 )	\$(24 )	\$(420 )

<b>Net sales by product</b>	<b>2016</b>	<b>2015</b>	<b>2014</b>
Packaged sales			
Astaxanthin packaged	\$18,347	\$17,579	\$11,663
Astaxanthin packaged sales increase	4.4 %	50.7 %	65.4 %
Spirulina packaged	\$7,282	\$7,192	\$5,562
Spirulina packaged sales increase	1.3 %	29.3 %	7.9 %
Total Packaged sales	\$25,629	\$24,771	\$17,225
Total Packaged sales increase	3.5 %	43.8 %	41.1 %
Bulk sales			
Astaxanthin bulk	\$1,482	\$4,508	\$7,393
Astaxanthin bulk sales (decrease) increase	(67.1 )%	(39.0 )%	(36.1 )%
Spirulina bulk	\$4,729	\$4,530	\$3,560
Spirulina bulk sales increase (decrease)	4.4 %	27.2 %	(3.4 )%
Total Bulk sales	\$6,211	\$9,038	\$10,953
Total Bulk sales (decrease)	(31.3 )%	(17.5 )%	(28.2 )%

**Fiscal 2016 results compared with Fiscal 2015**

**Net Sales** The net sales decline of 5.8% in fiscal 2016 was driven primarily by a reduction of bulk astaxanthin sales due to lower production. Sales of our spirulina products grew 2.5%, driven by a 4.4% increase in bulk sales and a 1.3% increase in packaged sales. Our astaxanthin sales decreased 10.2% from the prior year, driven by a 67.1% decrease in bulk sales, offset by a 4.4% increase in packaged sales. Both spirulina and astaxanthin are sold in consumer packaged goods distributed primarily in the U.S. and in bulk form for use worldwide and we will continue to focus on growing the market for our high quality, higher margin consumer products by emphasizing the higher nutritional content of our Hawaiian spirulina and the benefits of our natural astaxanthin over synthetics; however, increased competition may result in the decline of margins in the future. Two customers accounted for 30% of our total revenue in fiscal 2016, compared to one customer who accounted for 13% of revenue in fiscal 2015.

Competition for sales of spirulina remains intense due to the large number of suppliers. We expect competitive pricing pressure to continue in future periods and will continue to focus on the higher quality of Hawaiian spirulina in support of customers who demand higher quality raw materials for their formulations. Conversely, because of the limited number of suppliers and increasing demand for astaxanthin, the competitive forces are currently not quite as high. Because of this, we expect current producers to increase capacity to meet this increasing demand, placing further competitive pressures on us in the future.

**Gross Profit** Our gross profit percent of net sales decreased by 5.5 percentage points compared to fiscal 2015. Gross profit was impacted by a 14% decrease in astaxanthin production, which resulted in a higher cost per kilo of astaxanthin sold during the year. Our production was impacted by lower sunlight and an unusual level of mid-day cloud cover in Kona, HI in the first two quarters of fiscal 2016 as a result of the El Nino conditions we experienced. We incurred \$0.5 million of non-inventoriable costs during fiscal 2016, including \$0.4 million related to start-up costs of our new extraction facility. In fiscal 2015, we incurred \$0.2 of non-inventoriable costs. The decline in gross profit was also due to changes in our customer mix in the first three quarters of the year, which resulted in higher overall sales allowances and reduced gross profit by \$0.9 or 3.6 percentage points during fiscal 2016 compared with fiscal 2015.

**Operating Expenses** Operating expenses decreased by \$1.5 million, or 11%, in fiscal 2016 and decreased as a percentage of net sales by 2.1%. General and Administrative expenses decreased \$2.1 million, or 26%, due to a decrease in legal fees of \$2.5 million related to matters that were settled in the third quarter of fiscal 2015, offset by higher salaries and benefits (\$0.2 million) and costs related to the Company's separation with its former CEO as of March 31, 2106 (\$0.5 million). Sales and Marketing expenses increased \$0.6 million, or 10%, as a result of the expansion of our distribution of consumer products. A major component of this increase is product demonstration costs which are up by \$0.9 million, offset by a decrease of \$0.3 million in advertising and promotion costs. Research and development expenses increased \$0.1 million, or 22%, due to an increase in salaries and benefits.

**Other Expense** Other expense is comprised primarily of interest expense on term loans, amortization of debt issuance costs and interest on other financing agreements, offset by a nominal amount of interest earned and miscellaneous sales.

**Income Taxes** For fiscal 2016 we recorded a valuation allowance of \$3.6 million against our remaining deferred tax asset, resulting in an income tax expense of \$3.3 million and an effective tax rate of (312%). In fiscal 2015, income tax expense was \$0.3 million, an effective tax rate of 111%.

#### **Fiscal 2015 results compared with Fiscal 2014**

**Net Sales** The net sales growth of 20.0% in fiscal 2015 was driven by increased demand for both spirulina and *BioAstin*® astaxanthin, fueled by ongoing marketing efforts to expand consumer awareness on the health benefits of both. Our spirulina products benefited from marketing efforts focused on promoting its health benefits and experienced 28.5% growth, driven by a 27.2% increase in bulk sales and a 29.3% increase in packaged sales. Our astaxanthin sales increased 15.9% over the prior year, driven by a 50.7% increase in packaged sales, offset by a 39.0% decrease in bulk sales. This reduction in bulk sales was the result of higher demand for packaged products in mass retail channels and lower astaxanthin production in the third and fourth quarters which affected the supply available for bulk sales. Both spirulina and astaxanthin are sold in consumer packaged goods distributed primarily in the U.S. and in bulk form for use worldwide.

**Gross Profit** Our gross profit percent of net sales was 3.1% higher than the prior year as a result of increased sales in our consumer packaged products. In fiscal 2015, decreased astaxanthin production volume impacted gross profit unfavorably by \$0.8 million of abnormal costs. In fiscal 2014, decreased astaxanthin production volume impacted gross profit unfavorably by \$1.7 million, including abnormal costs of \$0.4 million. A 44% increase in sales of our higher margin consumer products was offset by a 17.5% decrease in bulk sales in the current fiscal year.

In fiscal 2015, compared to fiscal 2014, astaxanthin production levels decreased by 3.7% and spirulina production levels increased by 3.3%. The decrease in astaxanthin production levels was the result of unusual weather conditions and resulting environmental factors that affected the quantity, but not the quality, of our astaxanthin produced during the third and fourth quarters of fiscal 2015.

**Operating Expenses** Operating expenses increased by \$2.7 million, or 24%, in fiscal 2015 and increased as a percentage of net sales by 1.3%. General and Administrative expenses increased \$1.4 million, or 23%, due to an increase in legal fees of \$1.1 million related to matters that were settled in the third quarter of fiscal 2015, an increase in compensation costs related to salaries and benefits for new hires and transfers of \$0.1 million and the accrual of a management bonus of \$0.2 million. Sales and Marketing expenses increased \$1.2 million, or 27%, as a result of the expansion of our distribution of consumer products. Major components of these costs are a \$0.5 million increase in advertising and promotion, \$0.2 million in bank charges and outside commission related to sales volume increases and \$0.2 million increase in compensation costs related to salary adjustments, benefits and new hires. Research and development expenses increased \$0.04 million, or 10%.

**Other Expense** Other expense is comprised primarily of interest expense on term loans, amortization of debt issuance costs and interest on other financing agreements, offset by a nominal amount of interest earned and miscellaneous sales.

**Income Taxes** For fiscal 2015 we recorded income tax expense of \$253,000, representing an effective tax rate of 111%, compared with income tax expense of \$92,000 in 2014. Our effective tax rate was 28% for the fiscal year ended March 31, 2014 due to the low pretax income and permanent book to tax difference related to stock option compensation.

### **Liquidity and Capital Resources**

**Sources of Liquidity** As of March 31, 2016, we had \$6.5 million in working capital, compared to \$7.5 million at March 31, 2015.

On May 27, 2016, we executed a short-term loan agreement with First Foundation Bank in the amount of \$0.6 million, with an interest rate of 5.5%, to be repaid by December 3, 2016. Funds generated by operating activities and available cash and cash equivalents continue to be our most significant sources of liquidity for working capital requirements and for funding of maintenance levels of capital equipment, leasehold improvements and system upgrades. Based upon our current operating plan, analysis of our consolidated financial position and projected future results of operations, we believe that our operating cash flows and existing cash balances will be sufficient to finance current operating requirements and meet debt service and planned capital expenditures, for the next 12 months. We use estimates of future financial results including projected revenue, fund expenses, borrowings, and capital expenditures in reaching our conclusions. Such estimates are subject to change based on future results and such change could cause future results to vary significantly from expected results presented in this Form 10-K. Any significant investments in capital equipment related to capacity expansion may not be able to be funded from operating activities and available cash, and may require additional debt or equity funding.

Our results of operations and financial condition can be affected by numerous factors, many of which are beyond our control and could cause future results of operations to fluctuate materially as it has in the past. Future operating results may fluctuate as a result of changes in sales volumes to our largest customers, weather patterns, increased competition, increased materials, nutrient and energy costs, government regulations and other factors beyond our control.

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

shortfall. We may also choose to reduce prices or increase spending in response to market conditions, which may have a material adverse effect on financial condition and results of operations.

### Contractual Obligations

The following table presents our contractual obligations at March 31, 2016 (in thousands):

	<b>Less Than 1 Year</b>	<b>2-3 Years</b>	<b>4-5 Years</b>	<b>After 5 Years</b>	<b>Total</b>
Term Loans(1)	\$504	\$1,092	\$1,225	\$4,586	\$7,407
Capital Leases	69	119	73	—	261
Interest payments(2)	417	729	584	1,391	3,121
Operating Leases(3)	614	1,220	1,154	4,820	7,808
Purchase obligations(4)	896	—	—	—	896
<b>Total</b>	<b>\$2,500</b>	<b>\$3,160</b>	<b>\$3,036</b>	<b>\$10,797</b>	<b>\$19,493</b>

Note: For additional information refer to Note 5, *Long-Term Debt* and Note 6, *Leases* in the Notes to Consolidated Financial Statements, included in Item 8, *Financial Statements and Supplementary Data*, of this Annual Report on Form 10-K.

(1) Includes term loans with a balance of \$7,403,000 as of March 31, 2016, secured by substantially all of the assets of the Company.

(2) Interest calculated from loan amortization using current rates.

(3) Operating lease obligations do not include percentage rent, property taxes and payments for common area maintenance.

(4) Purchase obligations include agreements to purchase goods or services that are enforceable, are legally binding and specify all significant terms, including fixed or minimum quantities to be purchased; fixed, minimum or variable price provisions; and the approximate timing of the transaction. Purchase obligations do not include agreements that are cancelable without penalty.

**Cash Flows** The following table summarizes our cash flows from operating, investing and financing activities for each of the past three fiscal years (\$ in thousands):

	<b>2016</b>	<b>2015</b>	<b>2014</b>
Total cash is provided by (used in):			
Operating activities	\$745	\$1,208	\$2,149
Investing activities	(3,817)	(3,297)	(2,125)
Financing activities	2,086	3	(76 )
Decrease in cash and cash equivalents	\$(986 )	\$(2,086)	\$(52 )

The decrease in cash provided by operating activities from \$1.2 million in fiscal 2015 to \$0.7 million in fiscal 2016 is due primarily to higher increases in inventories and accounts payable. The decrease in cash provided by operating activities from \$2.1 million in fiscal 2014 to \$1.2 million in fiscal 2015 was due to a higher increase in receivables offset by a lower increase in inventory.

Net cash used in investing activities increased \$0.5 million in fiscal 2016 compared to fiscal 2015 due primarily to higher self-funded capital expenditures over and above the use of the remaining restricted cash provided for the completion of our new extraction and warehouse facility. Net cash used in investing activities increased in fiscal 2015 compared to fiscal 2014 due to the use of restricted cash for equipment and leasehold improvements, as well as the construction of a new office facility at the Kona headquarters.



Cash used in financing activities during fiscal 2016 included proceeds from long-term debt to fund our \$2.5 million capacity expansion. Cash used in financing activities in fiscal 2015 and 2014 consist mainly of the proceeds from stock option exercises and the servicing of debt acquired during fiscal 2013.

### **Effect of Recently Issued Accounting Standards and Estimates**

In March 2016, the FASB issued Accounting Standards Update (“ASU”) 2016-09, “*Compensation – Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting*” (“ASU No. 2016-09”). This ASU makes several modifications to Topic 718 related to the accounting for forfeitures, employer tax withholding on share-based compensation, and the financial statement presentation of excess tax benefits or deficiencies. ASU No. 2016-09 also clarifies the statement of cash flows presentation for certain components of share-based awards. The standard is effective for interim periods beginning after December 15, 2016, with early adoption permitted. The Company expects to adopt this guidance when effective and is currently evaluating the effect that the updated standard will have on its consolidated financial statements and related disclosures.

In February 2016, the FASB issued ASU 2016-02, “*Leases (Topic 842)*” (“ASU No. 2016-02”). The principle objective of ASU No. 2016-02 is to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet. ASU No. 2016-02 continues to retain a distinction between finance and operating leases but requires lessees to recognize a right-of-use asset representing its right to use the underlying asset for the lease term and a corresponding lease liability on the balance sheet for all leases with terms greater than twelve months. ASU No. 2016-02 is effective for fiscal years and interim periods beginning after December 15, 2018. Early adoption of ASU No. 2016-02 is permitted. The Company is currently assessing the impact this standard may have on its consolidated financial statements and the related disclosures.

In November 2015, the FASB issued ASU No. 2015-17, “*Income Taxes (Topic 740): Balance Sheet Classification of Deferred Taxes*”. This guidance simplifies the presentation of deferred income taxes and requires that deferred tax assets and liabilities be classified as noncurrent in the classified statement of financial position. This guidance is effective for the Company as of March 31, 2018 and is not expected to have a material impact on the consolidated financial statements as the guidance only changes the classification of deferred income taxes.

In August 2015, the FASB issued ASU 2015-14, “*Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date*”, which defers the effective date of ASU 2014-09 by one year to December 15, 2017 for interim and annual reporting periods beginning after that date and permitted early adoption of the standard, but not before the original effective date. The Company expects to adopt this guidance when effective and is currently evaluating the effect that the updated standard will have on its consolidated financial statements and related disclosures.

In July 2015, the FASB issued ASU No. 2015-11, "Inventory: Simplifying the Measurement of Inventory", that requires inventory not measured using either the last in, first out (LIFO) or the retail inventory method to be measured at the lower of cost and net realizable value. Net realizable value is the estimated selling prices in the ordinary course of business, less reasonably predictable cost of completion, disposal, and transportation. The new standard will be effective for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years, and will be applied prospectively. Early adoption is permitted. The Company is evaluating the impact that this standard will have on its consolidated financial statements.

In April 2015, the FASB issued ASU No. 2015-03, "Interest – Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs," which requires debt issuance costs related to a recognized debt liability to be presented in the balance sheet as a direct deduction from the debt liability rather than as an asset. ASU 2015-03 is effective for fiscal years beginning after December 15, 2015. Early adoption is permitted. Upon adoption, an entity must apply the new guidance retrospectively to all prior periods presented in the financial statements, and must provide certain disclosures about the change in accounting principle, including the nature of and reason for the change, the transition method, a description of the prior-period information that has been retrospectively adjusted and the effect of the change on the financial statement line items (that is, debt issuance cost asset and the debt liability). The implementation of this guidance is not expected to have a material impact on the Company's consolidated financial statements.

### **Application of Critical Accounting Policies and Estimates**

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of financial statements in conformity with those accounting principles requires management to make judgments and estimates that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates. Management regularly re-evaluates its judgments and estimates which are based upon historical experience and on various other assumptions that are believed to be reasonable under the circumstances. Management believes that of its significant accounting policies, policies that may involve a higher degree of judgment and complexity are inventory valuations, valuation of equipment and leasehold improvements and long-lived assets, and income taxes.

*Revenue* - We recognize revenues when the customer takes ownership and assumes the risk of loss. We have determined that transfer of title and risk of loss generally occurs when product is received by the customer, except in instances where the shipment terms are explicitly FOB Origin, and accordingly we recognize revenue at the point of delivery to the customer. For shipments with terms of FOB Origin where transfer of title and risk of loss occurs at the point of shipping, revenue is recognized upon shipment to the customer. Sales returns and allowances are estimated and recorded as a reduction to sales in the period in which sales are recorded. We record net shipping charges and sales tax in cost of goods sold.

*Inventory* - We record inventories at the lower of cost or market. Cost is defined as the sum of the applicable expenditures and charges directly or indirectly incurred in bringing inventories to their existing condition and location. Cost for inventory purposes may be determined under any one of several assumptions as to the flow of cost factors, such as first-in, first-out; average cost; and last-in, first-out. Our inventories are stated using the first-in, first-out method. Inventory values are subject to many critical estimates, including production levels and capacity, changes in the prices paid for raw materials, supplies, and labor, changes in yield, potency, and quality of biomass, changes in processing or production methods, and changes in the carrying value of our inventories resulting from the prices our customers are willing to pay for our products. Such estimates are revised quarterly. Changes in management's estimates could result in increases or decreases in the recorded amounts of inventory and cost of sales.

To the extent that our production levels are not sufficient to absorb all production costs on a period basis, we recognize abnormal production costs, including fixed cost variances from normal production capacity, as an expense in the period incurred. Abnormal amounts of freight, handling costs and wasted material (spoilage) are recognized as current-period charges and fixed production overhead costs are allocated to inventory based on the normal capacity of production facilities. Normal capacity is defined as "the production expected to be achieved over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance." Changes in management's estimates could result in increases or decreases in the recorded amounts of inventory and cost of sales.

Management reviews inventory levels, inventory turnover, product age and product marketability quarterly to evaluate recoverability and determine if a reserve for inventory is deemed necessary. At March 31, 2016 an inventory reserve in the amount of \$8,000 has been recorded, compared to \$4,000 as of March 31, 2015.

*Equipment and leasehold improvements* - Equipment and leasehold improvements are reported at cost less accumulated depreciation and amortization. Self-constructed leasehold improvements include design, construction and supervision costs. These costs are recorded in construction in progress and are transferred to equipment and leasehold improvements when construction is completed and the facilities are placed in service. Long-lived assets, such as property, plant and equipment and purchased intangibles subject to amortization are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to the estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized to the extent that the carrying amount

exceeds the asset's fair value. We have not recognized any impairment of long lived assets as of March 31, 2016 or 2015.

*Stock-Based Compensation* - We provide compensation benefits in the form of stock options to employees and non-employee directors. Our stock options are service based, and the cost of stock-based compensation is recorded at fair value at the date of grant and expensed in the consolidated statement of operations over the service period. The fair value of service-based stock option awards is estimated on the date of grant using the Black-Scholes option pricing model and is recognized in expense over the vesting period of the options using the straight-line method. The Black-Scholes option pricing model requires various assumptions, including the expected volatility of our stock, the expected term of the option, the risk-free interest rate and the expected dividend yield. Expected volatility is based on historical volatility of our common stock. The risk-free rate for the expected term of the option is based on the U.S. Treasury yield curve in effect at the time of grant. We recognize compensation expense for only that portion of stock based awards that are expected to vest. We utilize historical employee termination behavior to determine our estimated forfeiture rates. If the actual forfeitures differ from those estimated by management, adjustments to compensation expense will be made in future periods. See Note 8 in the Notes to our consolidated financial statements included in this 10-K.

*Income taxes* - Income taxes are accounted for under the asset and liability method. The asset and liability method requires the recognition of deferred tax assets and liabilities for the expected future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their tax bases and operating loss and tax credit carry forwards. Deferred tax assets and liabilities are measured using enacted income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be recovered or settled. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible.

Our judgment is required in determining any valuation allowance recorded against deferred tax assets, specifically net operating loss carryforwards, tax credit carryforwards and deductible temporary differences that may reduce taxable income in future periods. In assessing the need for a valuation allowance, we consider all available evidence including past operating results, estimates of future taxable income and tax planning opportunities. In the event we change our determination as to the amount of deferred tax assets that can be realized, we will adjust our valuation allowance with a corresponding impact to income tax expense in the period in which such determination is made.

**Item 7A. Quantitative and Qualitative Disclosures about Market Risk**

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

We have two term loans with interest rates that adjust quarterly based on the prime rate. As such, we are exposed to the interest rate risk whereby a 1% increase in the prime rate would lead to an increase of approximately \$74,000 in interest expense for the year ending March 31, 2017 (based on March 31, 2016 amounts outstanding).

**Item 8. Financial Statements and Supplementary Data**

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

The Board of Directors and Shareholders

Cyanotech Corporation

We have audited the accompanying consolidated balance sheets of Cyanotech Corporation (a Nevada corporation) and subsidiary (the “Company”) as of March 31, 2016 and 2015, and the related consolidated statements of operations, stockholders’ equity and cash flows for each of the three years in the period ended March 31, 2016. Our audits of the basic consolidated financial statements included the financial statement schedule listed in the index appearing under Item 15(a)(2). These financial statements and financial statement schedule are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company’s internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company’s internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Cyanotech Corporation and subsidiary as of March 31, 2016 and 2015, and the results of their operations and their cash flows for each of the three years in the period ended March 31, 2016 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the related financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

/s/ GRANT THORNTON LLP

Irvine, California

June 23, 2016

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## CYANOTECH CORPORATION AND SUBSIDIARY

## CONSOLIDATED BALANCE SHEETS

March 31,

	2016	2015
	(in thousands, except share data)	
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$1,240	\$2,226
Accounts receivable, net of allowance for doubtful accounts of \$136 in 2016 and \$6 in 2015	2,983	3,258
Inventories, net	7,856	5,678
Deferred tax assets	74	315
Prepaid expenses and other current assets	502	317
Total current assets	12,655	11,794
Equipment and leasehold improvements, net	17,796	14,754
Restricted cash	—	486
Deferred tax assets	—	3,035
Other assets	696	846
Total assets	\$31,147	\$30,915
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Current maturities of long-term debt	\$574	\$234
Customer deposits	117	31
Accounts payable	4,000	2,926
Accrued expenses	1,430	1,124
Total current liabilities	6,121	4,315
Long-term debt, less current maturities	7,094	5,109
Deferred tax liabilities	74	—
Deferred rent	30	8
Total liabilities	13,319	9,432
Commitments and contingencies		
Stockholders' equity:		
Preferred stock of \$0.01 par value, authorized 10,000,000 shares; no shares issued and outstanding	—	—
Common stock of \$0.02 par value, authorized 50,000,000 shares; issued and outstanding 5,599,797 shares at March 31, 2016 and 5,564,799 shares at March 31, 2015	112	111
Additional paid-in capital	31,585	30,846



Accumulated deficit	(13,869)	(9,474)
Total stockholders' equity	17,828	21,483
Total liabilities and stockholders' equity	\$31,147	\$30,915

See accompanying notes to consolidated financial statements

## CYANOTECH CORPORATION AND SUBSIDIARY

## CONSOLIDATED STATEMENTS OF OPERATIONS

Year ended March 31,

	2016	2015	2014
	(in thousands, except per share data)		
Net sales	\$31,840	\$33,809	\$28,178
Cost of sales	19,974	19,343	16,989
Gross profit	11,866	14,466	11,189
Operating expenses:			
General and administrative	5,785	7,864	6,415
Sales and marketing	6,222	5,667	4,469
Research and development	633	517	469
Loss on sale or disposal of assets	11	96	46
Total operating expense	12,651	14,144	11,399
(Loss) income from operations	(785 )	322	(210 )
Other expense:			
Interest expense, net	(282 )	(93 )	(118 )
Total other expense, net	(282 )	(93 )	(118 )
Income before income tax expense	(1,067 )	229	(328 )
Income tax expense	(3,328 )	(253 )	(92 )
Net loss	\$(4,395 )	\$(24 )	\$(420 )
Net loss per share:			
Basic and diluted	\$(0.79 )	\$(0.00 )	\$(0.08 )
Shares used in calculation of net loss per share:			
Basic and diluted	5,581	5,517	5,478

See accompanying notes to consolidated financial statements

## CYANOTECH CORPORATION AND SUBSIDIARY

## CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

Years ended March 31, 2016, 2015 and 2014

	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital	Accumulated Deficit	Total Stockholders' Equity
	(in thousands, except per share data)				
Balances at March 31, 2013	5,463,938	\$ 109	\$ 29,077	\$ (9,030)	) \$ 20,156
Issuances of common stock for Director Stock Grants	9,000	1	50	—	51
Issuance of common stock for exercise of stock options for cash	15,100	—	36	—	36
Compensation expense related to stock options	—	—	728	—	728
Net loss	—	—	—	(420)	) (420)
Balances at March 31, 2014	5,488,038	110	29,891	(9,450)	) 20,551
Issuances of common stock for Director Stock Grants	16,561	—	78	—	78
Issuance of common stock for exercise of stock options for cash	60,200	1	214	—	215
Compensation expense related to stock options	—	—	663	—	663
Net loss	—	—	—	(24)	) (24)
Balances at March 31, 2015	5,564,799	111	30,846	(9,474)	) 21,483
Issuances of common stock for Director Stock Grants	13,198	—	78	—	78
Issuance of common stock for exercise of stock options for cash	21,800	1	74	—	75
Compensation expense related to stock options	—	—	587	—	587
Net loss	—	—	—	(4,395)	) (4,395)
Balances at March 31, 2016	5,599,797	\$ 112	\$ 31,585	\$ (13,869)	) \$ 17,828

See accompanying notes to consolidated financial statements



## CYANOTECH CORPORATION AND SUBSIDIARY

## CONSOLIDATED STATEMENTS OF CASH FLOWS

Years ended March 31,

	2016	2015	2014
	(in thousands)		
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net loss	\$(4,395)	\$(24 )	\$(420 )
Adjustments to reconcile net loss to cash provided by operating activities:			
Loss on sale or disposal of assets	11	96	46
Depreciation and amortization	1,520	1,243	1,086
Amortization of debt issue costs and other assets	57	56	43
Share based compensation expense	665	741	770
Provision for allowance for doubtful accounts	130	—	—
Deferred income tax expense	3,350	163	68
Net (increase) decrease in assets:			
Accounts receivable	145	(882 )	1,132
Inventories	(2,149)	(337 )	(1,513)
Prepaid expenses and other assets	(39 )	22	(249 )
Net increase (decrease) in liabilities:			
Customer deposits	86	1	(3 )
Accounts payable	1,036	(219 )	1,332
Accrued expenses	306	348	(130 )
Deferred rent	22	—	(13 )
Net cash provided by operating activities	745	1,208	2,149
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Investment in equipment and leasehold improvements	(4,303)	(4,179)	(4,117)
Proceeds from restricted cash	486	882	1,992
Net cash used in investing activities	(3,817)	(3,297)	(2,125)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Proceeds from short term notes payable	500	—	—
Payment of short term notes payable	(500 )	—	—
Proceeds from long-term debt, net of costs	2,407	—	—
Payments on capitalized leases	(44 )	(2 )	—
Principal payments on long-term debt	(352 )	(210 )	(116 )
Proceeds from issuance of common stock and exercise of stock options	75	215	40
Net cash provided by (used in) financing activities	2,086	3	(76 )
Net decrease in cash and cash equivalents	(986 )	(2,086)	(52 )

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Cash and cash equivalents at beginning of year	2,226	4,312	4,364
Cash and cash equivalents at end of year	\$1,240	\$2,226	\$4,312

SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:

Cash paid during the year for:

Interest	\$362	\$294	\$259
Income taxes	\$47	\$8	\$132

See accompanying notes to consolidated financial statements

## **CYANOTECH CORPORATION AND SUBSIDIARY**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

#### **Note 1 Description of Business and Summary of Accounting Policies**

##### **Description of Business**

Cyanotech Corporation (the “Company”) cultivates and produces high-value, high-quality natural products derived from microalgae for the nutritional supplements market. The Company currently cultivates, on a large-scale basis, two microalgal species from which its two major product lines are derived. The Company manufactures all of its products in the United States and sells its products worldwide. As the Company’s operations are solely related to microalgae-based products, management of the Company considers its operations to be in one industry segment. Correspondingly, the Company records revenue and cost of sales information by product category.

##### **Basis of Presentation**

The accompanying consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America. The accompanying consolidated financial statements include the accounts of Cyanotech Corporation and its wholly owned subsidiary, Nutrex Hawaii, Inc. (“Nutrex Hawaii” or “Nutrex”). All significant intercompany balances and transactions have been eliminated in consolidation.

##### **Estimates and Assumptions**

The preparation of the consolidated financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of any contingent assets and liabilities as of the date of the financial statements and the reported amounts of revenues and expenses during the period reported. Management reviews these estimates and assumptions periodically and reflects the effect of revisions in the period that they are determined to be necessary. Actual results could differ significantly from those estimates and assumptions. Significant estimates include inventory valuation and determination of production capacity and abnormal product costs, reserve for inventory, allowance for bad debts and valuation of deferred tax assets.

## Financial Instruments

Cash primarily consists of cash on hand and cash in bank deposits.

The Company applies a framework for measuring fair value. That framework provides a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (level 1 measurements) and the lowest priority to unobservable inputs (level 3 measurements). The three levels of the fair value hierarchy are described below:

Level 1 Inputs to the valuation methodology are unadjusted quoted prices for identical assets or liabilities in active — markets that the Company has the ability to access.

Level 2 Inputs to the valuation methodology include:

Quoted prices for similar assets or liabilities in active markets;

Quoted prices for identical or similar assets or liabilities in inactive markets;

Inputs other than quoted prices that are observable for the asset or liability; and

Inputs that are derived principally from or corroborated by observable market data by correlation or other means.

If the asset or liability has a specified (contractual) term, the Level 2 input must be observable for substantially the full term of the asset or liability.

Level 3 Inputs to the valuation methodology are unobservable and significant to the fair value.



*Cash and Cash Equivalents, Accounts Receivable and Accounts Payable* - Due to the short-term nature of these instruments, management believes that the carrying amounts approximate fair value.

*Long-Term Debt* - The carrying amount of long-term debt approximates fair value as interest rates applied to the underlying debt are adjusted quarterly to market interest rates, which approximate current interest rates for similar debt instruments of comparable maturities.

### **Concentration of Credit Risk**

The Company maintains its cash accounts with several banks located in Hawaii. The total cash balances are insured by the Federal Deposit Insurance Corporation ("FDIC") up to \$250,000 per bank. The Company had cash balances at March 31, 2016 that exceeded the balance insured by the FDIC by \$979,000. Two customers accounted for 19% and 11%, respectively, of total net sales in the fiscal year ended March 31, 2016. Two customers accounted for 44% of accounts receivable at March 31, 2016. One customer accounted for 13% of revenue for the fiscal year ended March 31, 2015. Two customers each accounted for 10% or more of accounts receivable at March 31, 2015. Our top ten customers generated 58% and 55% of our net sales during fiscal 2016 and fiscal 2015, respectively.

### **Accounts Receivable and Allowance for Doubtful Accounts**

Accounts receivable are recorded at the invoiced amount and do not accrue interest. The allowance for doubtful accounts reflects management's best estimate of probable credit losses inherent in the accounts receivable balance. Management determines the allowance based on historical experience, specifically identified nonpaying accounts and other currently available evidence. Management reviews its allowance for doubtful accounts monthly with a focus on significant individual past due balances over 90 days. All other balances are reviewed on a pooled basis. Account balances are charged off against the allowance after all means of collection have been exhausted and the potential for recovery is considered remote. The Company does not have any off-balance sheet credit exposure related to its customers.

### **Inventories, net**

Inventories are stated at the lower of cost or market. Cost is determined using the first-in, first-out (FIFO) method. Market is defined as sales price less cost to dispose and a normal profit margin. Inventory costs include materials, labor, overhead and third party costs.

Management provides a reserve against inventory for known or expected inventory obsolescence. The reserve is determined by specific review of inventory items for product age and quality which may affect salability. At March 31, 2016 and 2015, the inventory reserve was \$8,000 and \$4,000, respectively.

The Company recognizes abnormal production costs, including fixed cost variances from normal production capacity, as an expense in the period incurred. Abnormal amounts of freight, handling costs and wasted material (spoilage) are recognized as current period charges and fixed production overhead costs are allocated to inventory based on the normal capacity of production facilities. Normal capacity is defined as “the production expected to be achieved over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance.” The Company expensed abnormal production costs of \$395,000, \$639,000 and \$306,000 to cost of sales for the fiscal years ended March 31, 2016, 2015 and 2014, respectively. Non-inventoriable fixed costs were \$149,000, \$182,000 and \$91,000 for the fiscal years ended March 31, 2016, 2015 and 2014, respectively, and have been classified in cost of sales.

#### **Equipment and Leasehold Improvements, net**

Equipment and leasehold improvements are stated at cost. Depreciation and amortization are provided using the straight-line method over the estimated useful lives for equipment and furniture and fixtures, and the shorter of the land lease term (see Notes 3 and 6) or estimated useful lives for leasehold improvements as follows:

Equipment (in years)	3 to 10
Furniture and fixtures (in years)	3 to 7
Leasehold improvements (in years)	10 to 25

Capital project costs are accumulated in construction-in-progress until completed, at which time the costs are transferred to the relevant asset and commence depreciation. Repairs and Maintenance costs are expensed in the period incurred. Repairs and maintenance that significantly increase the useful life or value of the asset are capitalized and depreciated over the remaining life of the asset. The Company capitalizes interest cost incurred on funds used to construct property, plant, and equipment. The capitalized interest is recorded as part of the asset to which it relates and is amortized over the asset’s estimated useful life. Interest cost capitalized was \$173,000, \$228,000 and \$199,000 for the fiscal years ended March 31, 2016, 2015 and 2014, respectively.

### **Impairment of Long-Lived Assets**

Management reviews long-lived assets, such as equipment, leasehold improvements and purchased intangibles subject to amortization for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to the estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized to the extent that the carrying amount exceeds the asset's fair value. Assets to be disposed of and related liabilities would be separately presented in the consolidated balance sheet. Assets to be disposed of would be reported at the lower of the carrying value or fair value less costs to sell and would not be depreciated.

### **Accounting for Asset Retirement Obligations**

Management evaluates quarterly the potential liability for asset retirement obligations under the Company's lease for its principal facility and corporate headquarters. No liability has been recognized as of March 31, 2016 and 2015 (see Note 6).

### **Revenue Recognition**

We recognize revenues when the customer takes ownership and assumes the risk of loss. We have determined that transfer of title and risk of loss generally occurs when product is received by the customer, except in instances where the shipment terms are explicitly FOB Origin, and accordingly we recognize revenue at the point of delivery to the customer. For shipments with terms of FOB Origin where transfer of title and risk of loss occurs at the point of shipping, revenue is recognized upon shipment to the customer. Sales returns and allowances are estimated and recorded as a reduction to sales in the period in which sales are recorded. We record net shipping charges and sales tax in cost of goods sold.

### **Research and Development**

Research and development costs are expensed as incurred and consist primarily of labor, benefits and outside research.

### **Advertising**

Advertising costs are expensed as incurred. Total advertising expense for the years ended March 31, 2016, 2015 and 2014 was \$942,000, \$1,082,000 and \$1,126,000, respectively.

## **Income Taxes**

Income taxes are accounted for under the asset and liability method. The asset and liability method requires the recognition of deferred tax assets and liabilities for the expected future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their tax bases and operating loss and tax credit carry forwards. Deferred tax assets and liabilities are measured using income tax rates applicable to the period in which the tax difference is expected to reverse.

Judgment is required in determining any valuation allowance recorded against deferred tax assets, specifically net operating loss carryforwards, tax credit carryforwards and deductible temporary differences that may reduce taxable income in future periods. In assessing the need for a valuation allowance, we consider all available evidence including past operating results, estimates of future taxable income and tax planning opportunities. In the event we change our determination as to the amount of deferred tax assets that can be realized, we will adjust our valuation allowance with a corresponding impact to income tax expense in the period in which such determination is made.

In evaluating a tax position for recognition, management evaluates whether it is more-likely-than-not that a position will be sustained upon examination, including resolution of related appeals or litigation processes, based on the technical merits of the position. If the tax position meets the more-likely-than-not recognition threshold, the tax position is measured and recognized in the Company's financial statements as the largest amount of tax benefit that, in management's judgment, is greater than 50% likely of being realized upon settlement. As of March 31, 2016 and 2015, there was no significant liability for income tax associated with unrecognized tax benefits.

The Company recognizes accrued interest related to unrecognized tax benefits as well as any related penalties in interest expense in its condensed consolidated statements of operations. As of the date of adoption and during the years ended March 31, 2016, and 2015, there was no accrual for the payment of interest and penalties related to uncertain tax positions.

## Share-Based Compensation

The Company accounts for share-based payment arrangements using fair value. If an award vests or becomes exercisable based on the achievement of a condition other than service, such as for meeting certain performance or market condition, the award is classified as a liability. Liability-classified awards are remeasured to fair value at each balance sheet date until the award is settled. The Company currently has no liability-classified awards.

Equity-classified awards, including grants of employee stock options, are measured at the grant-date fair value of the award and are not subsequently remeasured unless an award is modified. The cost of equity-classified awards is recognized in the income statement over the period during which an employee is required to provide the service in exchange for the award, or the vesting period. All of the Company's stock options are service-based awards, and considered equity-classified awards; as such, they are reflected only in Equity and Compensation Expense accounts.

The Company utilizes the Black-Scholes option pricing model to determine the fair value of each option award. Expected volatilities are based on the historical volatility of the Company's common stock over a period consistent with that of the expected term of the options. The expected term of the options are estimated based on factors such as vesting periods, contractual expiration dates and historical exercise behavior. The risk-free rates for periods within the contractual life of the options are based on the yields of U.S. Treasury instruments with terms comparable to the estimated option terms.

## Per Share Amounts

Basic earnings per common share is calculated by dividing net income for the year by the weighted average number of common shares outstanding during the year. Diluted earnings per common share is calculated by dividing net income for the year by the sum of the weighted average number of common shares outstanding during the year plus the number of potentially dilutive common shares ("dilutive securities") that were outstanding during the year. Dilutive securities include options granted pursuant to the Company's stock option plans, potential shares related to the Employee Stock Purchase Plan and Restricted Stock grants to employees and non-employees. Dilutive securities related to the Company's stock option plans are included in the calculation of diluted earnings per common share using the treasury stock method. Potentially dilutive securities are excluded from the computation of earnings per share in periods in which a net loss is reported, as their effect would be antidilutive. A reconciliation of the numerators and denominators of the basic and diluted earnings per common share calculations for the years ended March 31, 2016, 2015 and 2014 is presented in Note 10.

## New Accounting Pronouncements

In March 2016, the FASB issued Accounting Standards Update (“ASU”) 2016-09, “*Compensation – Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting*” (“ASU No. 2016-09”). This ASU makes several modifications to Topic 718 related to the accounting for forfeitures, employer tax withholding on share-based compensation, and the financial statement presentation of excess tax benefits or deficiencies. ASU No. 2016-09 also clarifies the statement of cash flows presentation for certain components of share-based awards. The standard is effective for interim periods beginning after December 15, 2016, with early adoption permitted. The Company expects to adopt this guidance when effective and is currently evaluating the effect that the updated standard will have on its consolidated financial statements and related disclosures.

In February 2016, the FASB issued ASU 2016-02, “*Leases (Topic 842)*” (“ASU No. 2016-02”). The principle objective of ASU No. 2016-02 is to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet. ASU No. 2016-02 continues to retain a distinction between finance and operating leases but requires lessees to recognize a right-of-use asset representing its right to use the underlying asset for the lease term and a corresponding lease liability on the balance sheet for all leases with terms greater than twelve months. ASU No. 2016-02 is effective for fiscal years and interim periods beginning after December 15, 2018. Early adoption of ASU No. 2016-02 is permitted. The Company is currently assessing the impact this standard may have on its consolidated financial statements and the related disclosures.

In November 2015, the FASB issued ASU No. 2015-17, “*Income Taxes (Topic 740): Balance Sheet Classification of Deferred Taxes*”. This guidance simplifies the presentation of deferred income taxes and requires that deferred tax assets and liabilities be classified as noncurrent in the classified statement of financial position. This guidance is effective for the Company as of March 31, 2018 and is not expected to have a material impact on the consolidated financial statements as the guidance only changes the classification of deferred income taxes.

In August 2015, the FASB issued ASU 2015-14, “*Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date*”, which defers the effective date of ASU 2014-09 by one year to December 15, 2017 for interim and annual reporting periods beginning after that date and permitted early adoption of the standard, but not before the original effective date. The Company expects to adopt this guidance when effective and is currently evaluating the effect that the updated standard will have on its consolidated financial statements and related disclosures.

In July 2015, the FASB issued ASU No. 2015-11, “*Inventory: Simplifying the Measurement of Inventory*”, that requires inventory not measured using either the last in, first out (LIFO) or the retail inventory method to be measured at the lower of cost and net realizable value. Net realizable value is the estimated selling prices in the ordinary course of business, less reasonably predictable cost of completion, disposal, and transportation. The new standard will be effective for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years, and will be applied prospectively. Early adoption is permitted. The Company is evaluating the impact that this standard will have on its consolidated financial statements.

In April 2015, the FASB issued ASU No. 2015-03, “*Interest – Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs*,” which requires debt issuance costs related to a recognized debt liability to be presented in the balance sheet as a direct deduction from the debt liability rather than as an asset. ASU 2015-03 is effective for fiscal years beginning after December 15, 2015. Early adoption is permitted. Upon adoption, an entity must apply the new guidance retrospectively to all prior periods presented in the financial statements, and must provide certain disclosures about the change in accounting principle, including the nature of and reason for the change, the transition method, a description of the prior-period information that has been retrospectively adjusted and the effect of the change on the financial statement line items (that is, debt issuance cost asset and the debt liability). The implementation of this guidance is not expected to have a material impact on the Company’s consolidated financial statements.

## Note 2 Inventories, net

Inventories consist of the following as of March 31, 2016 and 2015:

	<b>2016</b>	<b>2015</b>
	<b>(in thousands)</b>	
Raw materials	\$375	\$931
Work in process	3,782	1,509
Finished goods(1)	3,543	2,895
Supplies	156	343
	<b>\$7,856</b>	<b>\$5,678</b>

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(1) Net of reserve for obsolescence of \$8,000 and \$4,000 at March 31, 2016 and 2015, respectively.

## Note 3 Equipment and Leasehold Improvements, net

Equipment and leasehold improvements consists of the following as of March 31, 2016 and 2015:

	<b>2016</b>	<b>2015</b>
	<b>(in thousands)</b>	
Equipment(1)	\$17,040	\$9,782
Leasehold improvements	13,797	10,216

Furniture and fixtures	354	298
	31,191	20,296
Less accumulated depreciation and amortization	(14,067)	(12,549)
Construction in-progress	672	7,007
	\$17,796	\$14,754

(1) Includes \$314,000 of equipment under capital lease at March 31, 2016, with accumulated amortization of \$41,000.

The Company reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying value of such assets may not be recoverable. No such event occurred during the fiscal years ended March 31, 2016, 2015 and 2014. The Company recognized a loss on disposal of equipment and leasehold improvements in the amount of \$11,000, \$96,000 and \$46,000 in fiscal 2016, 2015 and 2014 respectively. Depreciation and amortization expense was \$1,546,000, \$1,270,000 and \$1,086,000 for the years ended March 31, 2016, 2015 and 2014, respectively.

The Company has capitalized interest in the amount of \$173,000, \$228,000 and \$199,000 for the fiscal years ended March 31, 2016, 2015 and 2014, respectively.

#### Note 4 Accrued Expenses

Components of accrued expenses as of March 31, 2016 and 2015 are as follows:

	<b>2016</b>	<b>2015</b>
	<b>(in thousands)</b>	
Wages, commissions, bonus and profit sharing	\$972	\$930
Use tax	140	—
Customer rebates	74	74
Rent and utilities	49	118
Other accrued expenses	195	2
	\$1,430	\$1,124



**Note 5 Long-Term Debt**

Long-term debt consists of the following as of March 31, 2016 and 2015 as follows:

	<b>2016</b>	<b>2015</b>
	<b>(in thousands)</b>	
Long-term debt	\$7,668	\$5,343
Less current maturities	(574 )	(234 )
Long-term debt, excluding current maturities	\$7,094	\$5,109

*Term Loans*

The Company executed a loan agreement with a lender providing for \$2,500,000 in aggregate credit facilities (the “2015 Loan”) secured by substantially all the Company’s assets, pursuant to a Term Loan Agreement dated July 30, 2015 (the “2015 Loan Agreement”). The 2015 Loan Agreement is evidenced by a promissory note in the amount of \$2,500,000, the repayment of which is partially guaranteed under the provisions of a United States Department of Agriculture (“USDA”) Rural Development Guarantee program. The proceeds of the 2015 Loan were used to pay off a \$500,000 short term note payable that matured on September 18, 2015, acquire new processing equipment and leasehold improvements at the Company’s Kona, Hawaii facility.

The provisions of the 2015 Loan require the payment of principal and interest until its maturity on September 1, 2022, the obligation fully amortizes over seven (7) years. Interest on the 2015 Loan accrues on the outstanding principal balance at an annual variable rate equal to the published Wall Street Journal prime rate (3.50% at March 31, 2016) plus 2.0% and is adjustable on the first day of each calendar quarter and fixed for that quarter. At no time shall the annual interest rate be less than 6.00%. The 2015 Loan has a prepayment penalty of 5% for any prepayment made prior to the first anniversary of the date of the 2015 Loan Agreement, which penalty is reduced by 1% each year thereafter until the fifth anniversary of such date, after which there is no prepayment penalty. The balance under the 2015 Loan was \$2,354,000 at March 31, 2016.

The 2015 Loan includes a one-time origination and guaranty fee totaling \$113,900 and an annual renewal fee payable in the amount of 0.50% of the USDA guaranteed portion of the outstanding principal balance as of December 31 of each year, beginning December 31, 2015. The USDA has guaranteed 80% of all amounts owing under the 2015 Loan. The Company is subject to financial covenants and customary affirmative and negative covenants.

The Company executed a loan agreement with a lender providing for \$5,500,000 in aggregate credit facilities (the “Loan”) secured by substantially all the Company’s assets, including a mortgage on the Company's interest in its lease at the National Energy Laboratory of Hawaii Authority, pursuant to a Term Loan Agreement dated August 14, 2012 (the “Loan Agreement”). The Loan Agreement is evidenced by promissory notes in the amounts of \$2,250,000 and \$3,250,000, the repayment of which is partially guaranteed under the provisions of a USDA Rural Development Guarantee. The proceeds of the Loan have been used to acquire new processing equipment and leasehold improvements at its Kona, Hawaii facility.

The provisions of the Loan required the payment of interest only for the first 12 months of the term; thereafter, and until its maturity on August 14, 2032, the obligation fully amortizes over nineteen (19) years. Interest on the Loan accrues on the outstanding principal balance at an annual variable rate equal to the published Wall Street Journal prime rate (3.50% at March 31, 2016) plus 1.0% and is adjustable on the first day of each calendar quarter and fixed for that quarter. At no time shall the annual interest rate be less than 5.50%. The Loan has a prepayment penalty of 5% for any prepayment made prior to the first anniversary of the date of the Loan Agreement, which penalty is reduced by 1% each year thereafter until the fifth anniversary of such date, after which there is no prepayment penalty. The balance under this Loan was \$5,049,000 and \$5,236,000 at March 31, 2016 and 2015, respectively. Proceeds from the Loan were classified as restricted cash until drawn upon to acquire new processing equipment and leasehold improvements.

The Loan included a one-time origination and guaranty fees totaling \$214,500 and an annual renewal fee payable in the amount of 0.25% of the USDA guaranteed portion of the outstanding principal balance as of December 31 of each year, beginning December 31, 2012. The USDA has guaranteed 80% of all amounts owing under the Loan. The Company is subject to financial covenants and customary affirmative and negative covenants.

The Company’s current ratio of 1.97 fell short of the bank’s requirement of 2.10; however, the Company has received a letter from its bank stating they found the Company to be in compliance with this and all other financial covenants as of March 31, 2016 and does not consider this shortfall to be a default under the Loan Agreements.

On May 27, 2016, we executed a short-term loan agreement with First Foundation Bank in the amount of \$600,000, with an interest rate of 5.5%, to be repaid by December 3, 2016.

### *Capital Leases*

In February 2016, the Company executed a capital lease agreement with Bank of the West providing for \$51,000 in equipment, secured by the equipment financed. The capital lease matures in March 2021 and is payable in 60 equal monthly payments. The interest rate under this capital lease is 4.18%. The balance under this lease was \$50,000 and \$0 at March 31, 2016 and March 31, 2015, respectively.

In July 2015, the Company executed a capital lease agreement with Huntington Technology Finance providing for \$174,000 in equipment, secured by the equipment financed. The capital lease matures in July 2020 and is payable in 60 equal monthly payments. The interest rate under this capital lease is 6.57%. The balance under this lease was \$152,000 and \$0 at March 31, 2016 and March 31, 2015, respectively.

In March 2015, the Company executed a capital lease agreement with Thermo Fisher Financial providing for \$86,000 in equipment, secured by the equipment financed. The capital lease matures in March 2018 and is payable in 36 equal monthly payments. The interest rate under this capital lease is 6.5%. The balance under this lease was \$59,000 and \$84,000 at March 31, 2016 and 2015, respectively.

Future principal payments under the loan and capital lease agreements as of March 31, 2016 are as follows:

<b>Year ending March 31</b>	<b>(in thousands)</b>
2017	\$ 574
2018	604
2019	608
2020	643
2021	654
Thereafter	4,585
Total principal payments	\$ 7,668

#### **Note 6 Leases**

The Company's principal facility and its corporate headquarters are located at the Natural Energy Laboratory of Hawaii Authority ("NELHA") at Keahole Point in Kailua-Kona, Hawaii. The property is leased from the State of Hawaii under a 40-year commercial lease expiring in 2035. Under the terms of the existing NELHA lease, the Company could be required to remove improvements at the end of the lease term. Under generally accepted accounting principles in the United States, an entity should recognize the fair value of a liability for an asset retirement obligation in the period in which the retirement obligation is incurred, if a reasonable estimate of fair value can be made. If such an estimate cannot be made in the period the asset retirement obligation is incurred, the liability should be recognized when the fair value can be reasonably estimated. Based on communications with NELHA, management does not believe the projected cost for such removal to be material to the consolidated financial statements, or likely, given historical practices. However, conditions could change in the future. It is not possible to predict such changes or estimate any impact thereof.

The Company leases facilities, equipment and land under operating leases expiring through 2035. The land lease provides for contingent rentals in excess of minimum rental commitments based on a percentage of the Company's sales. Contingent rental payments for the years ended March 31, 2016, 2015 and 2014 were \$65,000, \$67,000 and \$73,000, respectively.

Future minimum lease payments under non-cancelable operating leases at March 31, 2016 are as follows:

<b>Year ending March 31</b>	<b>(in thousands)</b>
2017	\$ 614
2018	607

2019	613
2020	622
2021	532
Thereafter	4,820
Total minimum lease payments	\$ 7,808

Rent expense, including contingent rent, under operating leases amounted to \$622,000, \$626,000 and \$578,000 for the years ended March 31, 2016, 2015 and 2014, respectively.

## Note 7 Commitments and Contingencies

On May 24, 2016, a shareholder of the Company, Meridian OHC Partners, LP, filed a complaint in the United States District Court, District of Nevada, entitled *Meridian OHC Partners, LP vs. Cyanotech Corporation, Michael Davis and Rudolf Steiner Foundation (RSF), Inc.* The complaint makes certain derivative claims on behalf of the Company, direct claims on behalf of Meridian, and alleges, among other things, (i) that there were deficiencies in the beneficial ownership reports of Mr. Davis, the Chairman of our Board of Directors, and RSF, a shareholder of the Company, including that Mr. Davis and RSF are an undisclosed group with respect to their shares of Company Common Stock, (ii) that Mr. Davis has failed to disclose control over his full voting power of the Company's Common Stock in order to avoid triggering the State of Nevada's "Acquisition of Controlling Interest" statutes, and (iii) that Mr. Davis has breached fiduciary duties to the Company. Meridian seeks declaratory and injunctive relief to reform this conduct, requests that the court award the Company the damages allegedly sustained as a result of the conduct, seeks relief directly against Mr. Davis and RSF and seeks other relief.

The Board of Directors of the Company has formed a Special Committee comprised of independent directors to investigate, review and analyze the Meridian allegations and provide its recommendations to the Board.

On March 31, 2016, the Company entered into a Separation Agreement and Release of Claims, pursuant to which Brent Bailey, now-former CEO, resigned from the Company effective as of the date of the Separation Agreement. Under the Separation Agreement, Mr. Bailey is eligible to receive (1) an aggregate of \$325,000 in separation payments, payable monthly through the end of April 2017, and (2) up to 155,000 shares of the Company's Common Stock, to be granted in two tranches. On April 29, 2016, the Company issued 48,467 shares of its Common Stock to Mr. Bailey in accordance with the Separation Agreement. In connection with the Separation and Release of Claims, the Company accrued separation expenses of \$360,000 as of March 31, 2016.

**Note 8 Share-Based Compensation***Stock Options*

As of March 31, 2016, the Company had one equity-based compensation plan: the Independent Director Stock Option and Restricted Stock Grant Plan (the “2014 Directors Plan”). The Company has also issued stock options, which remain outstanding as of March 31, 2016, under two equity-based compensation plans which have expired according to their terms: the 2005 Stock Option Plan (the “2005 Plan”) and the 2004 Independent Director Stock Option and Stock Grant Plan (the “2004 Directors Plan”). These plans allowed the Company to award stock options and shares of restricted common stock to eligible employees, certain outside consultants and independent directors.

On August 28, 2014, the Company’s shareholders approved the 2014 Directors Plan authorizing the Board of Directors to provide incentive to the Company’s independent directors through equity based compensation in the form of stock options and restricted stock. Awards under the 2014 Directors Plan are limited to the authorized amount of 350,000 shares. As of March 31, 2016, there were 314,241 shares available for grant under the 2014 Directors Plan.

The 2005 Plan and the 2004 Directors Plan have expired, and therefore no additional awards will be issued under those plans.

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

	<b>As of March 31, 2016</b>		
	<b>Authorized</b>	<b>Available</b>	<b>Outstanding</b>
2014 Directors Plan	350,000	314,241	6,000
2005 Plan	—	—	667,000
2004 Directors Plan	—	—	12,000
Total	350,000	314,241	685,000

All stock option grants made under the equity-based compensation plans were issued at exercise prices no less than the Company’s closing stock price on the date of grant. Options under the 2005 Plan and 2014 Directors Plan were determined by the Board of Directors or the Compensation Committee of the Board of Directors in accordance with the provisions of the respective plans. The terms of each option grant include vesting, exercise, and other conditions are set forth in a Stock Option Agreement evidencing each grant. No option can have a life in excess of ten (10) years.

The Company records compensation expense for employee stock options based on the estimated fair value of the options on the date of grant using the Black-Scholes option-pricing model. The model requires various assumptions, including a risk-free interest rate, the expected term of the options, the expected stock price volatility over the expected term of the options, and the expected dividend yield. Compensation expense for employee stock options is recognized ratably over the vesting term. Compensation expense recognized for options issued under the 2005 Plan was \$581,000, \$663,000 and \$715,000 for the years ended March 31, 2016, 2015 and 2014, respectively. Compensation expense recognized for restricted stock and stock options issued under the 2014 Directors Plan and the 2004 Directors Plan was \$84,000, \$78,000 and \$50,000 for the three years ended March 31, 2016, 2015 and 2014, respectively. All stock-based compensation has been classified as general and administrative expense in the consolidated statement of operations.

A summary of option activity under the Company's stock plans for the years ended March 31, 2016, 2015 and 2014 is presented below:

<b>Option Activity</b>	<b>Shares</b>	<b>Weighted Average Exercise Price</b>	<b>Weighted Average Remaining Contractual Term  (in years)</b>	<b>Aggregate Intrinsic Value</b>
Outstanding at March 31, 2013	1,495,856	\$ 4.03	8.3	\$1,174,810
Granted	6,000	\$ 5.56		
Exercised	(15,100 )	\$ 2.43		
Forfeited	(17,450 )	\$ 4.53		
Outstanding at March 31, 2014	1,469,306	\$ 4.04	7.3	\$2,034,303
Granted	45,000	\$ 4.72		
Exercised	(60,200 )	\$ 3.58		
Forfeited	(20,890 )	\$ 4.28		
Outstanding at March 31, 2015	1,433,216	\$ 4.08	6.4	\$6,221,909
Granted	6,000	\$ 5.91		
Exercised	(21,800 )	\$ 3.26		
Forfeited	(732,416 )	\$ 3.59		
Outstanding at March 31, 2016	685,000	\$ 4.65	5.7	\$566,323
Exercisable at March 31, 2016	513,750	\$ 4.29	5.4	\$527,203

The aggregate intrinsic value in the table above is before applicable income taxes and represents the excess amount over the exercise price optionees would have received if all options had been exercised on the last business day of the period indicated, based on the Company's closing stock price of \$4.98, \$8.42, \$5.24 and \$4.47 at March 31, 2016, 2015, 2014 and 2013 respectively. The total intrinsic value of stock options exercised during fiscal years 2016, 2015 and 2014 were \$58,000, \$167,000 and \$51,000, respectively.

A summary of the Company's non-vested options for the year ended March 31, 2016 is presented below:

<b>Nonvested Options</b>	<b>Shares</b>	<b>Weighted Average Grant-Date Fair Value</b>
Nonvested at March 31, 2015	614,416	\$ 3.25
Granted	6,000	1.18
Vested	(204,250)	3.19
Forfeited	(244,916)	2.92



Nonvested at March 31, 2016 171,250 \$ 3.75

The weighted average grant-date fair value of stock options granted during fiscal years 2016, 2015 and 2014 was \$7,000, \$123,000 and \$5,000, respectively. The total grant-date fair values of stock options that vested during fiscal years 2016, 2015 and 2014 were \$651,000, \$809,000 and \$763,000, respectively.

The following table summarizes the weighted average characteristics of outstanding stock options as of March 31, 2016:

Range of Exercise Prices	Outstanding Options			Exercisable Options	
	Number of Shares	Remaining Life (Years)	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price
\$1.60 - \$3.70	148,220	4.0	\$ 2.76	148,220	\$ 2.76
\$3.71 - \$4.42	194,780	5.4	\$ 3.82	167,780	\$ 3.82
\$4.43 - \$5.40	117,500	6.9	\$ 5.00	69,500	\$ 5.07
\$5.41 - \$7.08	224,500	6.4	\$ 6.42	128,250	\$ 6.26
Total stock options	685,000	5.7	\$ 4.65	513,750	\$ 4.29

The range of fair value assumptions related to options granted during the years ended March 31, 2016, 2015 and 2014 were as follows:

	2016		2015		2014	
Exercise Price	\$	5.91	\$	4.72		\$5.56
Volatility		50.00	%	64.00	%	38.00%
Risk Free Rate		0.22	%	1.74	%	0.14%
Vesting Period (in years)		0.5		3	5	- 7
Forfeiture Rate		0.00	%	4.51	%	0.00
Expected Life (in years)		1.00		5.73		1.00
Dividend Rate		0	%	0	%	0

As of March 31, 2016, total unrecognized stock-based compensation expense related to all unvested stock options was \$373,000, which is expected to be expensed over a weighted average period of 2.2 years.

### Note 9 Common and Preferred Stock

The Company has authorized a total of sixty million shares of which fifty million shares are authorized common stock and ten million shares are authorized preferred stock. None of the preferred stock was issued or outstanding at March 31, 2016 and 2015. Under the terms of the Company's Amended and Restated Articles of Incorporation, the Board of Directors is authorized to determine or alter the rights, preferences, privileges and restrictions of the Company's authorized but unissued shares of preferred stock.

### Note 10 Earnings Per Share

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

Reconciliations between the numerator and the denominator of the basic and diluted earnings per share computations for the years ended March 31, 2016, 2015 and 2014 are as follows:

	<b>Net Income (Numerator) (in thousands, except per share amounts)</b>	<b>Shares (Denominator)</b>	<b>Per Share Amount</b>
Year ended March 31, 2016:			
Basic and diluted loss per share	\$(4,395)	5,581	\$ (0.79 )
Year ended March 31, 2015:			
Basic and diluted loss per share	\$(24 )	5,517	\$ (0.00 )
Year ended March 31, 2014:			
Basic and diluted loss per share	\$(420 )	5,478	\$ (0.08 )

Basic and diluted loss per share are the same in periods of a net loss, because common share equivalents are anti-dilutive when a net loss is recorded. Diluted earnings per share does not include the impact of common stock options totaling 58,000, 634,000 and 725,000 for the fiscal years ending March 31, 2016, 2015 and 2014, respectively,

as the effect of their inclusion would be anti-dilutive.

#### **Note 11 Profit Sharing Plan and 401k Plan**

The Company sponsors a profit sharing plan for all employees not covered under a separate management incentive plan. Under the profit sharing plan, a percentage determined by the Board of Directors of pre-tax profits on a quarterly basis may be allocated to non-management employees at management's discretion. The profit sharing bonus may be distributed all in cash on an after-tax basis or distributed half in cash (on an after-tax basis) and the remainder deposited in an employee's 401(k) account on a pre-tax basis. Employees may also make voluntary pre-tax contributions to their 401(k) accounts. Compensation expense under this plan was approximately \$0, \$46,000 and \$17,000 for the fiscal years ended March 31, 2016, 2015 and 2014, respectively. Additionally, the Company makes a retirement contribution to all employees individual 401(k) accounts equal to two percent of each employee's base pay for each bi-weekly pay period on a pre-tax basis. Retirement expense under this plan was approximately \$147,000, \$113,000 and \$110,000 for fiscal years ended March 31, 2016, 2015 and 2014, respectively.

#### **Note 12 Major Customers and Geographic Information**

Net sales by product line for the years 2016, 2015 and 2014 are as follows:

	<b>2016</b>	<b>2015</b>	<b>2014</b>
	<b>(in thousands)</b>		
Net sales:			
Natural astaxanthin products			
BioAstin®	\$ 19,829	\$ 22,087	\$ 19,056
Spirulina products	12,011	11,722	9,122
	\$ 31,840	\$ 33,809	\$ 28,178

The following table presents sales for the years 2016, 2015 and 2014 by geographic region:

	<b>2016</b>		<b>2015</b>		<b>2014</b>	
	<b>(dollars in thousands)</b>					
Net sales(1):						
United States	\$22,711	71 %	\$24,049	71 %	\$17,355	62 %
Asia / Pacific	4,130	13 %	3,149	8 %	3,106	10 %
Europe	2,990	9 %	4,302	13 %	5,237	19 %
Other	2,009	7 %	2,309	8 %	2,480	9 %
	\$31,840	100 %	\$33,809	100 %	\$28,178	100 %

(1) Net sales are attributed to countries based on location of customer.

### Note 13 Income Taxes

Income tax (expense) benefit for the years ended March 31, 2016, 2015 and 2014 consisted of:

	<b>2016</b>	<b>2015</b>	<b>2014</b>
	<b>(in thousands)</b>		
Current:			
Federal	\$(1 )	\$(12 )	\$19
State	23	(78 )	(43 )
Total current benefit (expense)	22	(90 )	(24 )
Deferred:			
Federal	(3,027)	(170)	(25 )
State	(323 )	7	(43 )
Total deferred expense	(3,350)	(163)	(68 )
Income tax expense	\$(3,328)	\$(253)	\$(92 )

The following table reconciles the amount of income taxes computed at the federal statutory rate of 34%, for all periods presented, to the amount reflected in the Company's consolidated statements of operations for the years ended March 31, 2016, 2015 and 2014:

	<b>2016</b>	<b>2015</b>	<b>2014</b>
	<b>(in thousands)</b>		
Tax provision at federal statutory income tax rate	\$363	\$(78 )	\$111
State income taxes benefit (expense), net of federal income tax effect	25	(49 )	(17 )

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Increase in valuation allowance	(3,564)	—	—
Stock based compensation	(127 )	(108)	(199)
State rate adjustment	1	(4 )	(41 )
R&D credit	—	—	24
Other, net	(26 )	(14 )	30
Income tax expense	\$(3,328)	\$(253)	\$(92 )

The tax effects of temporary differences related to various assets, liabilities and carry forwards that give rise to deferred tax assets and deferred tax liabilities as of March 31, 2016 and 2015 are as follows:

	<b>2016</b>	<b>2015</b>
	<b>(in thousands)</b>	
Deferred tax assets:		
Net operating loss carry forwards	\$3,862	\$3,687
Compensation accrual	535	382
Tax credit carry forwards	147	157
Inventory	3	90
Other	72	46
Gross deferred tax assets	4,619	4,362
Less valuation allowance	(3,564)	—
Net deferred tax assets	1,055	4,362
Deferred tax liability- Depreciation and amortization	(1,055)	(1,012)
Net deferred tax assets	\$—	\$3,350

In assessing the valuation allowance for deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. Ultimately, the realization of deferred tax assets will depend on the existence future taxable income during the periods. In making this assessment, management considers past operating results, the scheduled reversal of deferred tax liabilities, estimates of future taxable income and tax planning strategies.

In fiscal 2016, the Company recorded a \$3,564,000 valuation allowance against deferred tax assets. The Company concluded that a valuation allowance was appropriate in light of the significant negative evidence, which was objective and verifiable, primarily the cumulative losses in recent years. While the Company's long-term financial outlook remains positive, the Company concluded that its ability to rely on its long-term outlook as to future taxable income was limited due to the relative weight of the negative evidence from its recent cumulative losses. The Company's conclusion regarding the need for a valuation allowance against its deferred tax assets could change in the future based on improvements in operating performance, which may result in the full or partial reversal of the valuation allowance.

There was no valuation allowance against deferred tax assets as of March 31, 2015.

At March 31, 2016, the Company has net operating loss carry forwards and tax credit carry forwards available to offset future federal income tax as follows (in thousands):

<b>Expires March 31,</b>	<b>Net Operating Losses</b>	<b>Research and Experimentation Tax Credits</b>
2020	\$ —	\$ 8
2021	—	2
2022	2,852	—
2023	1,863	1
2026	159	—
2027	2,665	1
2028	1,612	16
2031	389	—
2032	44	—
2033	76	—
2034	392	—
2035	18	
2036	535	
	\$ 10,605	\$ 28

In addition, at March 31, 2016, the Company has alternative minimum tax credit carry forwards of approximately \$120,000 available to reduce future federal regular income taxes over an indefinite period.

At March 31, 2016, the Company has state tax net operating loss carry forwards available to offset future California state taxable income of \$363,000. These carry forwards expire March 31, 2036. At March 31, 2016, the Company has state tax net operating loss carry forwards available to offset future Hawaii state taxable income of \$5,575,000. These carry forwards expire March 31, 2030 through 2036.

The following represents the open tax years and jurisdictions that the Company used in its evaluation of tax positions:

Open tax years ending March 31,	Jurisdiction
2013-2016	U.S. Federal
2013-2016	State of Hawaii
2012-2016	State of California

**Note 14 Selected Quarterly Financial Data (Unaudited)**

	First Quarter	Second Quarter	Third Quarter <sup>(1)</sup>	Fourth Quarter <sup>(1)</sup>	Year
	<b>(in thousands, except per share data)</b>				
<b>2016</b>					
Net sales	\$7,594	\$ 8,516	\$ 7,534	\$ 8,196	\$31,840
Gross profit	2,924	3,100	3,084	2,758	11,866
Net income (loss)	(105 )	14	(250 )	(4,054 )	(4,395 )
Net income (loss) per share Basic and diluted	(0.02 )	0.00	(0.04 )	(0.73 )	(0.79 )
<b>2015</b>					
Net sales	\$7,624	\$ 7,946	\$ 9,691	\$ 8,547	\$33,809
Gross profit	3,059	3,935	4,798	2,674	14,466
Net income	(381 )	64	463	(170 )	(24 )
Net income per share Basic and diluted	(0.07 )	0.01	0.08	(0.02 )	(0.00 )

(1) The first, second and third quarters of 2016 include abnormal costs of \$214,000, \$308,000 and \$21,000, respectively.

The first, third and fourth quarters of 2015 include abnormal costs of \$81,000, \$196,000 and \$607,000, respectively.



**Note 15 Subsequent Events**

In accordance with FASB Accounting Standards Codification Topic 855, the Company has evaluated through June 23, 2016, which is the date these consolidated financial statements were issued. All required recognition as of March 31, 2016 have been incorporated into these consolidated financial statements herein.

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## Item 9A. Controls and Procedures

### *Disclosure Controls and Procedures*

Under the supervision and with the participation of our management, including our chief executive officer (“CEO”) and chief financial officer (“CFO”), we have evaluated the effectiveness of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15(d)-15(e) of the Exchange Act as of the end of the period covered by this Report. Based on that evaluation, our CEO and CFO have concluded that our disclosure controls and procedures are effective to provide reasonable assurance that information we are required to disclose in reports we file or submit under the Exchange Act is (1) recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms and (2) accumulated and communicated to our management, including our CEO and CFO, as appropriate to allow timely decisions regarding required disclosures.

### *Management’s Report on Internal Control over Financial Reporting.*

The Company’s management is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act). The Company’s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Our management evaluated the effectiveness of our internal control over financial reporting as of March 31, 2016. This assessment was based on the framework in 1992 Internal Control—Integrated Framework, issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our assessment, using those criteria, management concluded that our internal control over financial reporting was effective as of March 31, 2016.

### *Changes in Internal Control over Financial Reporting.*

During Fiscal 2016, the Company implemented additional training programs for the personnel responsible for reviewing customer purchase orders in order to clarify and confirm transfer of title and risk of loss when customer purchase orders terms are vague or missing, including appropriate review and approval procedures as well as additional quarter end closing and review procedures to confirm delivery dates for all FOB Destination shipments.

There have not been any other changes in our internal control over financial reporting (as such term is defined in Rule 13a-15(f) and 15d-15(f) under the Exchange Act) during the fourth fiscal quarter that our certifying officers concluded materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

*Limitations on the Effectiveness of Controls.*

Our management, including our Chief Executive Officer and Chief Financial Officer, do not expect that our disclosure controls and procedures will prevent all errors and all fraud. A control system no matter how well designed and implemented, can provide only reasonable, not absolute, assurance that the control system's objectives will be met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues within a company are detected. The inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistakes. Controls can also be circumvented by the individual acts of some persons, or by collusion of two or more people. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

**Item 9B. Other Information**

Not applicable

## **PART III**

### **Item 10. Directors, Executive Officers of the Registrant and Corporate Governance**

Information with respect to Directors may be found under captions “Proposal One: Election of Directors,” “Board Meetings and Committees,” “Director Compensation,” “Security Ownership of Certain Beneficial Owners and Management: and “Compliance with Section 16(a) of the Exchange Act” contained in Cyanotech’s definitive 2016 Proxy Statement. Information on Executive Officers may be found under the caption “Executive Officers” contained in Cyanotech’s definitive 2016 Proxy Statement.

We have adopted the Cyanotech Code of Ethics for Chief Executive Officer and Senior Financial Officers (the “Code of Ethics”), which is included in our Code of Conduct and Ethics. We have also adopted the Board of Directors Code of Conduct. Both Codes are publicly available on our website at [www.cyanotech.com](http://www.cyanotech.com). If we make any substantive amendments to or grant any waiver from such Codes relating to our Chief Executive Officer, Chief Financial Officer or Controller, we will disclose the nature of such amendment in a report on Form 8-K and amend the website disclosure.

### **Item 11. Executive Compensation**

The information required by this Item is incorporated herein by reference from the sections captioned “Executive Compensation and Other Information,” “Equity Compensation Plan Information” and “Option Grants in Fiscal Year 2016,” contained in Cyanotech’s definitive 2016 Proxy Statement.

### **Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters**

The security ownership information required by this Item is incorporated herein by reference from the sections captioned “Equity Compensation Plan Information” and “Security Ownership of Certain Beneficial Owners and Management” contained in Cyanotech’s definitive 2016 Proxy Statement.

### **Item 13. Certain Relationships and Related Transactions, and Director Independence**

The information required by this Item, if any, is incorporated herein by reference from the sections captioned “Related Party Transactions” contained in Cyanotech’s definitive 2016 Proxy Statement.

**Item 14. Principal Accountant Fees and Services**

Information concerning principal accountant fees and services appears under the heading “Independent Registered Public Accounting Firm’s Fees” in Cyanotech’s definitive 2016 Proxy Statement.

**PART IV**

**Item 15. Exhibits and Financial Statement Schedule**

(a) Financial Statements and Schedule

- (1) The following Financial Statements of Cyanotech Corporation and subsidiary and the Report of Independent Registered Public Accounting Firm are included in Item 8 of this report:
- |   |    |
|---|----|
| Report of Independent Registered Public Accounting Firm   | 23 |
| Consolidated Balance Sheets as of March 31, 2016 and 2015   | 24 |
| Consolidated Statements of Operations for the years ended March 31, 2016, 2015 and 2014           | 25 |
| Consolidated Statements of Stockholders' Equity for the years ended March 31, 2016, 2015 and 2014 | 26 |
| Consolidated Statements of Cash Flows for the years ended March 31, 2016, 2015 and 2014           | 27 |
| Notes to Consolidated Financial Statements  | 28 |
- (2) The following financial statement schedule is included in this report on the pages indicated below:
- |   |    |
|---|----|
| Schedule II—Valuation and Qualifying Accounts | 45 |
|---|----|

Financial statement schedules not listed above have been omitted since they are either not required, not applicable or the information is included in the consolidated financial statements or notes thereto.

## (b)Exhibit Listing

<b>Exhibit Number</b>	<b>Document Description</b>
3.1	Restated Articles of Incorporation (Incorporated by reference to Exhibit 3.1 to the Company's Quarterly Report on Form 10-Q, filed November 9, 2012, File No. 0-14602).
3.2	Amended and Restated Bylaws (Incorporated by reference to Exhibit 3.2 to the Company's Report on Form 8-K filed January 13, 2010, File No. 0-14602)
4.1	Specimen Common Stock (Incorporated by reference to Exhibit 4.1 to the Company's Annual Report on Form 10-K for the year ended March 31, 2007, File No. 0-14602)
10.1	Sub-Lease Agreement between the Company and Natural Energy Laboratory of Hawaii Authority dated December 29, 1995 (Incorporated by reference to Exhibit 10.1 to the Company's Quarterly Report on Form 10-QSB for the quarter ended December 31, 1995, File No. 0-14602)
10.2	Supplemental Agreement effective February 1, 2012 to amend the Sub-Lease Agreement described in Exhibit 10.1 herein, (Incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K dated March 9, 2012, File No. 0-14602).
10.3	2004 Independent Director Stock Option and Restricted Stock Grant Plan, amended and restated November 8, 2011 (Incorporated by reference to Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q dated November 14, 2011 for the quarter ended September 30, 2011, File No. 0-14602).
10.4	2005 Stock Option Plan, amended August 29, 2011 (Incorporated by reference to Exhibit 10.2 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2011, File No. 0-14602).
10.5	Separation Agreement and Release of Claims, by and between Brent D. Bailey and the Registrant dated March 31, 2016 (Incorporated by reference as Exhibit 10.1 to the Company's Report on Form 8-K filed on April 4, 2016, File No. 0-14602)
10.6	Term Loan Agreement between Pacific Rim Bank ("Pacific Rim") and both Registrant and Nutrex Hawaii, Inc. ("Nutrex"); Promissory Notes in favor of Pacific Rim in the amounts of \$2,250,000 and \$3,250,000, issued by Registrant and Nutrex, dated September 7, 2012; Mortgage, Security Agreement and Financing Statement between Registrant and Pacific Rim; Assignment of Lessor's Interest in Leases and Rents between Registrant and Pacific Rim; Security Agreement and UCC Financing Statement between Registrant and Pacific Rim; United States Department of Agriculture Rural Development ("USDA") Conditional Commitments; Hazardous Substances Certificate and Indemnity Agreement; Assignment of Construction Contract between Registrant and No'Eau Construction LLC; Sublessor's Consent to Mortgage of Sublease K-4; Estoppel Certificate and Subordination Agreement, given by the Natural Energy Laboratory of Hawaii Authority, State of Hawaii, as Sublessor; Security Agreement and UCC Financing Statement between Nutrex and Pacific Rim. (Incorporated by reference as Exhibit 4.1 to the Company's Report on Form 10-Q filed on November 9, 2012, File No. 0-14602)
10.7	Term Loan Agreement between First Foundation Bank ("First Foundation") and both Registrant and Nutrex; Promissory Note in favor of First Foundation in the amount of \$2,500,000, issued by Registrant and Nutrex, dated July 30, 2015; Mortgage, Security Agreement and Financing Statement between Registrant and First Foundation; Assignment of Lessor's Interest in Leases and Rents between Registrant and First Foundation; Security Agreement and UCC Financing Statement between Registrant and First Foundation; Security Agreement and UCC Financing Statement between Nutrex and First Foundation; USDA Conditional Commitments; Hazardous Substances Certificate and Indemnity Agreement; Sublessor's Consent to Mortgage of Sublease K-4; Estoppel Certificate and Subordination Agreement. (Incorporated by reference as Exhibit 4.1 through 4.9 to the Company's Report on Form 10-Q filed on November 12, 2015, File No. 0-14602)

- 10.8 2014 Independent Director Stock Option and Restricted Stock Grant Plan (Incorporated by reference to the Company's Definitive Proxy Statement filed July 18, 2014, File No. 0-14602)
- 21.1 Subsidiaries of the Company (Incorporated by reference to Exhibit 21.1 to the Company's Annual Report on Form 10-K for the year ended March 31, 2012, File No. 0-14602)
- 23.1\* Consent of Independent Registered Public Accounting Firm signed June 23, 2016—Grant Thornton LLP
- 31.1\* Certifications of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 signed as of June 23, 2016.
- 31.2\* Certifications of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 signed as of June 23, 2016.
- 32.1\* Certifications of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 signed as of June 23, 2016.
- 99.1\* Press Release dated June 23, 2016
- 101 The following financial information from our Annual Report on Form 10-K for fiscal year ended March 31, 2016, filed with the SEC on June 23, 2016, formatted in XBRL (eXtensible Business Reporting Language): (i) the Consolidated Balance Sheets at March 31, 2016 and 2015, (ii) the Consolidated Statements of Operations for the years ended March 31, 2016, 2015 and 2014, (iii) the Consolidated Statements of Stockholders' Equity for the years ended March 31, 2016, 2015 and 2014, (iv) the Consolidated Statements of Cash Flows for the years ended March 31, 2016 and 2015, and (v) Notes to Consolidated Financial Statements.
- \* Included herewith. Other exhibits were filed as shown above.



**Schedule II****Cyanotech Corporation and Subsidiary****Valuation and Qualifying Accounts****Years Ended March 31, 2016, 2015 and 2014****(in thousands)**

<b>Description</b>	<b>Balance at Beginning of Year</b>	<b>Additions Charged to Costs and Expense</b>	<b>Charged to Other Accounts</b>	<b>Deductions</b>	<b>Balance at End of Year</b>
Allowance for Doubtful Accounts:					
2016	\$ 6	130	—	—	\$ 136
2015	6	—	—	—	6
2014	6	10	—	(10)	) 6

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) 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, on the 23th day of June, 2016.

**CYANOTECH CORPORATION**

By: /s/ Gerald R. Cysewski  
 Gerald R. Cysewski  
*Interim President and Chief Executive Officer; Director*

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

<b>Signatures</b>	<b>Title</b>	<b>Date</b>
/s/ Gerald R. Cysewski, PH.D. Gerald R. Cysewski	Interim President and Chief Executive Officer; Director	June 23, 2016
/s/ Jole Deal Jole Deal	Chief Financial Officer, Vice President—Finance and Administration, Secretary and Treasurer (Principal Financial and Accounting Officer)	June 23, 2016
/s/ Michael A. Davis Michael A. Davis	Chairman of the Board	June 23, 2016
/s/ Walter B. Menzel Walter B. Menzel	Director	June 23, 2016
/s/ David M. Mulder David M. Mulder	Director	June 23, 2016
/s/ David L. Vied David L. Vied	Director	June 23, 2016

Exhibit	Document Description
Number	
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10.8	2014 Independent Director Stock Option and Restricted Stock Grant Plan (Incorporated by reference to the Company's Definitive Proxy Statement filed July 18, 2014, File No. 0-14602)
21.1	

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Subsidiaries of the Company (Incorporated by reference to Exhibit 21.1 to the Company's Annual Report on Form 10-K for the year ended March 31, 2012, File No. 0-14602)

- 23.1\* Consent of Independent Registered Public Accounting Firm signed June 23, 2016—Grant Thornton LLP
- 31.1\* Certifications of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 signed as of June 23, 2016.
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- 99.1\* Press Release dated June 23, 2016

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- 101 (i) the Consolidated Balance Sheets at March 31, 2016 and 2015, (ii) the Consolidated Statements of Operations for the years ended March 31, 2016, 2015 and 2014, (iii) the Consolidated Statements of Stockholders' Equity for the years ended March 31, 2016, 2015 and 2014, (iv) the Consolidated Statements of Cash Flows for the years ended March 31, 2016 and 2015, and (v) Notes to Consolidated Financial Statements.

\* Included herewith. Other exhibits were filed as shown above.