

AeroVironment Inc  
Form 10-Q  
November 26, 2014  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

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**FORM 10-Q**

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

**For the quarterly period ended November 1, 2014**

**OR**

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

**For the transition period from            to**

**Commission File Number: 001-33261**

## **AEROVIRONMENT, INC.**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of incorporation or organization)

**95-2705790**

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

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

(Address of principal executive offices)

**91016**

(Zip Code)

**(626) 357-9983**

(Registrant's telephone number, including area code)

**N/A**

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

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

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

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

Large accelerated filer

Accelerated filer

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

Smaller reporting company

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

As of November 14, 2014, the number of shares outstanding of the registrant's common stock, \$0.0001 par value, was 23,321,876.

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**AeroVironment, Inc.**

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

|   | <b>November 1,<br/>2014<br/>(Unaudited)</b> | <b>April 30,<br/>2014</b> |
|---|---|---------------------------|
| <b>Assets</b>   |   |                           |
| Current assets:   |   |                           |
| Cash and cash equivalents   | \$ 126,339                                  | \$ 126,969                |
| Short-term investments  | 81,120                                      | 70,639                    |
| Accounts receivable, net of allowance for doubtful accounts of \$635 at<br>November 1, 2014 and \$791 at April 30, 2014 | 31,096                                      | 31,739                    |
| Unbilled receivables and retentions   | 7,103                                       | 10,929                    |
| Inventories, net  | 51,804                                      | 50,699                    |
| Income tax receivable   | 4,876                                       | 6,584                     |
| Deferred income taxes   | 4,996                                       | 5,038                     |
| Prepaid expenses and other current assets   | 4,233                                       | 4,260                     |
| Total current assets  | 311,567                                     | 306,857                   |
| Long-term investments   | 49,718                                      | 50,505                    |
| Property and equipment, net   | 16,889                                      | 19,997                    |
| Deferred income taxes   | 7,118                                       | 6,721                     |
| Other assets  | 837   | 874                       |
| Total assets  | \$ 386,129                                  | \$ 384,954                |
| <b>Liabilities and Stockholders Equity</b>  |   |                           |
| Current liabilities:  |   |                           |
| Accounts payable  | \$ 18,988                                   | \$ 13,906                 |
| Wages and related accruals  | 9,889                                       | 14,083                    |
| Customer advances   | 4,655                                       | 2,984                     |
| Other current liabilities   | 9,709                                       | 6,762                     |
| Total current liabilities   | 43,241                                      | 37,735                    |
| Deferred rent   | 1,231                                       | 1,239                     |
| Liability for uncertain tax positions   | 3,513                                       | 3,513                     |
| Commitments and contingencies   |   |                           |
| Stockholders' equity:   |   |                           |
| Preferred stock, \$0.0001 par value:  |   |                           |
| Authorized shares 10,000,000; none issued or outstanding  |   |                           |
| Common stock, \$0.0001 par value:   |   |                           |
| Authorized shares 100,000,000   |   |                           |
| Issued and outstanding shares 23,324,276 at November 1, 2014 and 23,176,576 at<br>April 30, 2014                        | 2   | 2                         |
| Additional paid-in capital  | 146,431                                     | 143,648                   |

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|  |            |            |
|--|------------|------------|
| Accumulated other comprehensive loss       | (859)      | (263)      |
| Retained earnings                          | 192,570    | 199,080    |
| Total stockholders' equity                 | 338,144    | 342,467    |
| Total liabilities and stockholders' equity | \$ 386,129 | \$ 384,954 |

See accompanying notes to consolidated financial statements (unaudited).

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

|   | Three Months Ended  |                     | Six Months Ended    |                     |
|---|---------------------|---------------------|---------------------|---------------------|
|   | November 1,<br>2014 | October 26,<br>2013 | November 1,<br>2014 | October 26,<br>2013 |
| <b>Revenue:</b>                             |                     |                     |                     |                     |
| Product sales                               | \$ 42,874           | \$ 51,537           | \$ 85,685           | \$ 78,711           |
| Contract services                           | 9,790               | 13,330              | 18,845              | 30,273              |
|   | 52,664              | 64,867              | 104,530             | 108,984             |
| <b>Cost of sales:</b>                       |                     |                     |                     |                     |
| Product sales                               | 27,779              | 32,143              | 58,576              | 52,698              |
| Contract services                           | 7,014               | 8,846               | 14,029              | 19,863              |
|   | 34,793              | 40,989              | 72,605              | 72,561              |
| <b>Gross margin:</b>                        |                     |                     |                     |                     |
| Product sales                               | 15,095              | 19,394              | 27,109              | 26,013              |
| Contract services                           | 2,776               | 4,484               | 4,816               | 10,410              |
|   | 17,871              | 23,878              | 31,925              | 36,423              |
| Selling, general and administrative         | 13,470              | 13,084              | 26,873              | 25,543              |
| Research and development                    | 8,531               | 6,861               | 15,655              | 14,051              |
| (Loss) income from operations               | (4,130)             | 3,933               | (10,603)            | (3,171)             |
| <b>Other income (expense):</b>              |                     |                     |                     |                     |
| Interest income                             | 193                 | 195                 | 405                 | 400                 |
| Other (expense) income                      | (583)               | (2,307)             | 8                   | (5,701)             |
| (Loss) income before income taxes           | (4,520)             | 1,821               | (10,190)            | (8,472)             |
| (Benefit) provision for income taxes        | (1,619)             | 166                 | (3,680)             | (2,917)             |
| Net (loss) income                           | \$ (2,901)          | \$ 1,655            | \$ (6,510)          | \$ (5,555)          |
| <b>(Loss) earnings per share data:</b>      |                     |                     |                     |                     |
| Basic                                       | \$ (0.13)           | \$ 0.07             | \$ (0.29)           | \$ (0.25)           |
| Diluted                                     | \$ (0.13)           | \$ 0.07             | \$ (0.29)           | \$ (0.25)           |
| <b>Weighted average shares outstanding:</b> |                     |                     |                     |                     |
| Basic                                       | 22,878,410          | 22,273,629          | 22,840,465          | 22,256,292          |
| Diluted                                     | 22,878,410          | 22,697,590          | 22,840,465          | 22,256,292          |

See accompanying notes to consolidated financial statements (unaudited).

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**AeroVironment, Inc.**

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

**(In thousands)**

|   | <b>Three Months Ended</b>   |                             | <b>Six Months Ended</b>     |                             |
|---|-----------------------------|-----------------------------|-----------------------------|-----------------------------|
|   | <b>November 1,<br/>2014</b> | <b>October 26,<br/>2013</b> | <b>November 1,<br/>2014</b> | <b>October 26,<br/>2013</b> |
| Net (loss) income                                 | \$ (2,901)                  | \$ 1,655                    | \$ (6,510)                  | \$ (5,555)                  |
| Other comprehensive (loss) income:                |                             |                             |                             |                             |
| Unrealized (loss) gain on investments, net of tax | (644)                       | 77                          | (596)                       | 29                          |
| Total comprehensive (loss) income                 | \$ (3,545)                  | \$ 1,732                    | \$ (7,106)                  | \$ (5,526)                  |

See accompanying notes to consolidated financial statements (unaudited).



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

|   | <b>Six Months Ended</b> |                    |
|---|-------------------------|--------------------|
|   | <b>November 1,</b>      | <b>October 26,</b> |
|   | <b>2014</b>             | <b>2013</b>        |
| <b>Operating activities</b>   |                         |                    |
| Net loss  | \$ (6,510)              | \$ (5,555)         |
| Adjustments to reconcile net loss to cash provided by (used in) operating activities:   |                         |                    |
| Depreciation and amortization   | 4,303                   | 4,504              |
| Provision for doubtful accounts   | (105)                   | 309                |
| Deferred income taxes   | 42                      | (233)              |
| Realized gain on sale of equity securities  | (347)                   |                    |
| Stock-based compensation  | 1,745                   | 1,840              |
| Foreign currency losses   | 281                     |                    |
| (Increase) decrease in fair value of conversion feature of convertible bonds  | (73)                    | 5,711              |
| Tax benefit from exercise of stock options  | 11                      | 151                |
| Excess tax benefit from stock-based compensation  | (348)                   |                    |
| Changes in operating assets and liabilities:  |                         |                    |
| Accounts receivable   | 748                     | (16,777)           |
| Unbilled receivables and retentions   | 3,826                   | 4,048              |
| Inventories   | (1,105)                 | 1,932              |
| Income tax receivable   | 1,708                   | 3,657              |
| Other assets  | (61)                    | 9                  |
| Accounts payable  | 5,082                   | (4,370)            |
| Other liabilities   | 764                     | (4,899)            |
| Net cash provided by (used in) operating activities   | 9,961                   | (9,673)            |
| <b>Investing activities</b>   |                         |                    |
| Acquisitions of property and equipment  | (1,070)                 | (6,047)            |
| Acquisitions of distribution and licensing rights   |                         | (750)              |
| Net (purchases) redemptions of held-to-maturity investments   | (19,586)                | 6,934              |
| Net sales of available-for-sale investments   | 9,038                   | 175                |
| Net cash (used in) provided by investing activities   | (11,618)                | 312                |
| <b>Financing activities</b>   |                         |                    |
| Excess tax benefit from exercise of stock options   | 348                     |                    |
| Exercise of stock options   | 679                     | 155                |
| Net cash provided by financing activities   | 1,027                   | 155                |
| Net decrease in cash and cash equivalents   | (630)                   | (9,206)            |
| Cash and cash equivalents at beginning of period  | 126,969                 | 75,332             |
| Cash and cash equivalents at end of period  | \$ 126,339              | \$ 66,126          |
| Supplemental disclosure:  |                         |                    |
| Unrealized loss (gain) on available-for-sale investments recorded in other comprehensive (loss) income, net of deferred taxes of \$397 and \$(18), respectively | \$ 596                  | \$ (29)            |

See accompanying notes to consolidated financial statements (unaudited).



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**AeroVironment, Inc.**

**Notes to Consolidated Financial Statements (Unaudited)**

**1. Organization and Significant Accounting Policies**

*Organization*

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

*Basis of Presentation*

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions of Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments, consisting only of normal recurring adjustments necessary for a fair presentation with respect to the interim financial statements have been included. The results of operations for the three and six months ended November 1, 2014, are not necessarily indicative of the results for the full year ending April 30, 2015. For further information, refer to the consolidated financial statements and footnotes thereto for the year ended April 30, 2014, included in the Company's Annual Report on Form 10-K.

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

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

*Segments*

The Company's products are sold and divided among two reportable segments to reflect the Company's strategic goals. Operating segments are defined as components of an enterprise from which separate financial information is available that is evaluated regularly by the Chief Operating Decision Maker (CODM) in deciding how to allocate resources and in assessing performance. The Company's CODM is the Chief Executive

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Officer, who reviews the revenue and gross margin results for each of these segments in order to make resource allocation decisions, including the focus of research and development ( R&D ) activities and performance assessment. The Company s reportable segments are business units that offer different products and services and are managed separately.

### *Investments*

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

### *Fair Values of Financial Instruments*

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

### *Government Contracts*

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

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

As of November 1, 2014 and April 30, 2014, the Company had \$4.7 million and \$2.1 million, respectively, in contract-related reserves for its estimate of potential refunds to customers for potential cost adjustments on U.S. government cost reimbursable contracts. For the three and six months ended November 1, 2014, the Company recorded \$2.6 million of expense in cost of sales for these contract-related reserves.

***(Loss) Earnings Per Share***

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

The reconciliation of basic to diluted shares is as follows:

|   | Three Months Ended  |                     | Six Months Ended    |                     |
|---|---------------------|---------------------|---------------------|---------------------|
|   | November 1,<br>2014 | October 26,<br>2013 | November 1,<br>2014 | October 26,<br>2013 |
| Denominator for basic (loss) earnings per share:  |                     |                     |                     |                     |
| Weighted average common shares outstanding, excluding unvested restricted stock                 | 22,878,410          | 22,273,629          | 22,840,465          | 22,256,292          |
| Dilutive effect of employee stock options, unvested restricted stock and restricted stock units |                     | 423,961             |                     |                     |
| Denominator for diluted (loss) earnings per share   | 22,878,410          | 22,697,590          | 22,840,465          | 22,256,292          |

Due to the net loss for the three months ended November 1, 2014 and the six months ended November 1, 2014 and October 26, 2013, no shares reserved for issuance upon exercise of stock options, restricted stock units or shares of unvested restricted stock were included in the computation of diluted loss per share as their inclusion would have been anti-dilutive. During the three months ended October 26, 2013, certain shares reserved for issuance upon exercise of stock options, shares of unvested restricted stock and restricted stock units were not included in the computation of diluted earnings per share because their inclusion would have been anti-dilutive. The number of shares reserved for issuance upon exercise of stock options, shares of unvested restricted stock and restricted stock units that met this anti-dilutive criterion for the three months ended October 26, 2013 was approximately 29,000.

***Recently Issued Accounting Standards***

In April 2014, the Financial Accounting Standards Board ( FASB ), issued Accounting Standards Update ( ASU ), No. 2014-08, *Presentation of Financial Statements (Topic 205) and Property, Plant, and Equipment (Topic 360): Reporting Discontinued Operations and Disclosures of*

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*Disposals of Components of an Entity.* This ASU changes the threshold for a disposal to qualify as a discontinued operation. To be considered a discontinued operation a disposal now must represent a strategic shift that has or will have a major effect on an entity's operations and financial results. This ASU also requires new disclosures for individually material disposal transactions that do not meet the definition of a discontinued operation. This update will be applied prospectively and is effective for annual periods, and interim periods within those years, beginning after December 15, 2014. Early adoption is permitted provided the disposal was not previously disclosed. The adoption of this guidance is not expected to have a material impact on the Company's consolidated financial statements.

In May 2014, the FASB issued ASU No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*. The new revenue recognition standard provides a five-step analysis of transactions to determine when and how revenue is recognized. The core principle is that a company should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. This ASU is effective for annual periods beginning after December 15, 2016 and shall be applied either retrospectively to each period presented or as a cumulative-effect adjustment as of the date of adoption. The Company is evaluating the potential impact of this adoption on its consolidated financial statements.

In June 2014, the FASB issued ASU No. 2014-12, *Compensation - Stock Compensation (Topic 718): Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period (a consensus of the FASB Emerging Issues Task Force)*. This ASU clarifies that a performance target that affects vesting and that could be achieved after the requisite service period be treated as a performance condition. A reporting entity should apply existing guidance in Topic 718 as it relates to awards with performance conditions that affect vesting to account for such awards. As such, the performance target should not be reflected in estimating the grant-date fair value of the award. Compensation cost should be recognized in the period in which it becomes probable that the performance target will be achieved and should represent the compensation cost attributable to the period(s) for which the requisite service has already been rendered. This ASU is effective for annual periods, and interim periods within those years, beginning after December 15, 2015. Early adoption is permitted. This ASU may be applied either (a) prospectively to all awards granted or modified after the effective date or (b) retrospectively to all awards with performance targets that are outstanding as of the beginning of the earliest annual period presented in the financial statements and to all new or modified awards thereafter. The adoption of this guidance is not expected to have a material impact on the Company's consolidated financial statements.

Table of Contents**AeroVironment, Inc.****Notes to Consolidated Financial Statements (Unaudited)****2. Investments**

Investments consist of the following (in thousands):

|                                      | November 1,<br>2014 | April 30,<br>2014 |
|--------------------------------------|---------------------|-------------------|
| Short-term investments:              |                     |                   |
| Held-to-maturity securities:         |                     |                   |
| Municipal securities                 | \$ 62,480           | \$ 69,898         |
| U.S. government securities           | 10,555              |                   |
| Certificates of deposit              | 3,883               | 741               |
| Total held-to-maturity investments   | 76,918              | 70,639            |
| Available-for-sale securities:       |                     |                   |
| Equity securities                    | 4,202               |                   |
| Total short-term investments         | \$ 81,120           | \$ 70,639         |
| Long-term investments:               |                     |                   |
| Held-to-maturity securities:         |                     |                   |
| Municipal securities                 | \$ 40,173           | \$ 29,759         |
| U.S. government securities           | 6,040               |                   |
| Certificates of deposit              | 744                 | 3,889             |
| Total held-to-maturity investments   | 46,957              | 33,648            |
| Available-for-sale securities:       |                     |                   |
| Auction rate securities              | 2,761               | 5,683             |
| Convertible bond                     |                     | 5,865             |
| Equity securities                    |                     | 5,309             |
| Total available-for-sale investments | 2,761               | 16,857            |
| Total long-term investments          | \$ 49,718           | \$ 50,505         |

**Held-To-Maturity Securities**

As of November 1, 2014 and April 30, 2014, the balance of held-to-maturity securities consisted of state and local government municipal securities, U.S. treasury securities and certificates of deposit. Interest earned from these investments is recorded in interest income.

The amortized cost, gross unrealized gains, gross unrealized losses, and estimated fair value of the held-to-maturity investments as of November 1, 2014, were as follows (in thousands):

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|                                    | Amortized<br>Cost |    | Gross<br>Unrealized<br>Gains |    | Gross<br>Unrealized<br>Losses |    | Fair Value |
|------------------------------------|-------------------|----|------------------------------|----|-------------------------------|----|------------|
| Municipal securities               | \$ 102,653        | \$ | 37                           | \$ | (30)                          | \$ | 102,660    |
| U.S. government securities         | 16,595            |    | 12                           |    |                               |    | 16,607     |
| Certificates of deposit            | 4,627             |    |                              |    |                               |    | 4,627      |
| Total held-to-maturity investments | \$ 123,875        | \$ | 49                           | \$ | (30)                          | \$ | 123,894    |



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

The amortized cost, gross unrealized gains, gross unrealized losses, and estimated fair value of the held-to-maturity investments as of April 30, 2014, were as follows (in thousands):

|                                    | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair Value |
|------------------------------------|-------------------|------------------------------|-------------------------------|------------|
| Municipal securities               | \$ 99,657         | \$ 65                        | \$ (9)                        | \$ 99,713  |
| Certificates of deposit            | 4,630             |                              |                               | 4,630      |
| Total held-to-maturity investments | \$ 104,287        | \$ 65                        | \$ (9)                        | \$ 104,343 |

The amortized cost and fair value of the held-to-maturity securities by contractual maturity at November 1, 2014, were as follows (in thousands):

|  | Cost       | Fair Value |
|--|------------|------------|
| Due within one year                    | \$ 76,918  | \$ 76,942  |
| Due after one year through three years | 46,957     | 46,952     |
| Total                                  | \$ 123,875 | \$ 123,894 |

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

As of November 1, 2014 and April 30, 2014, the entire balance of available-for-sale, auction rate securities, consisted of two and three investment grade auction rate municipal bonds, respectively, with maturities ranging from 5 to 20 years. These investments have characteristics similar to short-term investments, because at pre-determined intervals, generally ranging from 30 to 35 days, there is a new auction process at which the interest rates for these securities are reset to current interest rates. At the end of such period, the Company chooses to roll-over its holdings or redeem the investments for cash. A market maker facilitates the redemption of the securities and the underlying issuers are not required to redeem the investment within 365 days. Interest earned from these investments is recorded in interest income.

During the fourth quarter of the fiscal year ended April 30, 2008, the Company began experiencing failed auctions on some of its auction rate securities. A failed auction occurs when a buyer for the securities cannot be obtained and the market maker does not buy the security for its own account. The Company continues to earn interest on the investments that failed to settle at auction, at the maximum contractual rate until the next auction occurs. In the event the Company needs to access funds invested in these auction rate securities, the Company may not be able to liquidate these securities at the fair value recorded on November 1, 2014, until a future auction of these securities is successful or a buyer is found outside of the auction process.

As a result of the failed auctions, the fair values of these securities are estimated utilizing a discounted cash flow analysis as of November 1, 2014. The analysis considers, among other items, the collateralization underlying the security investments, the creditworthiness of the counterparty, the timing of expected future cash flows, and the estimated date upon which the security is expected to have a successful auction. Based on the Company's ability to access its cash and cash equivalents, expected operating cash flows, and other sources of cash, the Company does not anticipate the current lack of liquidity of these investments will affect its ability to operate the business in the ordinary course. The Company believes the current lack of liquidity of these investments is temporary and expects that the securities will be redeemed or refinanced at some point in the future. The Company will continue to monitor the value of its auction rate securities at each reporting period for a possible impairment if a further decline in fair value occurs. The auction rate securities have been in an unrealized loss position for more than 12 months. The Company has the ability and the intent to hold these investments until a recovery of fair value, which may be at maturity and as of November 1, 2014, the Company did not consider these investments to be other-than-temporarily impaired.

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

The amortized cost, gross unrealized gains, gross unrealized losses, and estimated fair value of the auction rate securities as of November 1, 2014, were as follows (in thousands):

|                                      | Amortized<br>Cost |    | Gross<br>Unrealized<br>Gains |    | Gross<br>Unrealized<br>Losses |    | Fair Value |
|--------------------------------------|-------------------|----|------------------------------|----|-------------------------------|----|------------|
| Auction rate securities              | \$ 3,200          | \$ |                              | \$ | (439)                         | \$ | 2,761      |
| Total available-for-sale investments | \$ 3,200          | \$ |                              | \$ | (439)                         | \$ | 2,761      |

The amortized cost, gross unrealized gains, gross unrealized losses, and estimated fair value of the available-for-sale investments as of April 30, 2014, were as follows (in thousands):

|                                      | Amortized<br>Cost |    | Gross<br>Unrealized<br>Gains |    | Gross<br>Unrealized<br>Losses |    | Fair Value |
|--------------------------------------|-------------------|----|------------------------------|----|-------------------------------|----|------------|
| Auction rate securities              | \$ 6,575          | \$ |                              | \$ | (892)                         | \$ | 5,683      |
| Total available-for-sale investments | \$ 6,575          | \$ |                              | \$ | (892)                         | \$ | 5,683      |

The amortized cost and fair value of the auction rate securities by contractual maturity at November 1, 2014, were as follows (in thousands):

|                                 | Cost     |    | Fair Value |
|---------------------------------|----------|----|------------|
| Due after five through 10 years | \$ 1,200 | \$ | 1,142      |
| Due after 10 years              | 2,000    |    | 1,619      |
| Total                           | \$ 3,200 | \$ | 2,761      |

**Convertible Bonds**

As of November 1, 2014 the Company does not have any convertible bonds outstanding. On August 11, 2014, the Company exercised its conversion right on its remaining convertible bond and the bond was converted into 1,062,699 CybAero common shares at the conversion price of 9.41 Swedish Kronor ( SEK ). The bond was in the amount of 10 million SEK. The maturity date of the bond was November 30, 2017.

**Equity Securities**

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As of November 1, and April 30, 2014, the entire balance of available-for-sale equity securities consisted of CybAero common shares. The shares are classified as available-for-sale. During the three and six months ended November 1, 2014, the Company realized gains of \$0.2 million and \$4.1 million, respectively, on the sale of CybAero shares.

The amortized cost, gross unrealized gains, gross unrealized losses, and estimated fair value of the equity securities as of November 1, 2014, were as follows (in thousands):

|                                      | <b>Amortized<br/>Cost</b> | <b>Gross<br/>Unrealized<br/>Gains</b> | <b>Gross<br/>Unrealized<br/>Losses</b> | <b>Fair Value</b> |
|--------------------------------------|---------------------------|---------------------------------------|--|-------------------|
| Equity securities                    | \$ 5,257                  | \$                                    | \$ (1,055)                             | \$ 4,202          |
| Total available-for-sale investments | \$ 5,257                  | \$                                    | \$ (1,055)                             | \$ 4,202          |

Table of Contents**AeroVironment, Inc.****Notes to Consolidated Financial Statements (Unaudited)****3. Fair Value Measurements**

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

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

The Company's financial assets measured at fair value on a recurring basis at November 1, 2014, were as follows (in thousands):

| Description             | Fair Value Measurement Using                                   |   |   | Total    |
|-------------------------|--|---|---|----------|
|                         | Quoted prices in active markets for identical assets (Level 1) | Significant other observable inputs (Level 2) | Significant unobservable inputs (Level 3) |          |
| Auction rate securities | \$   | \$  | \$ 2,761                                  | \$ 2,761 |
| Equity securities       | 4,202  |   |   | 4,202    |
| Total                   | \$ 4,202   | \$  | \$ 2,761                                  | \$ 6,963 |

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

**Description**

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|  | Fair Value<br>Measurements Using<br>Significant<br>Unobservable Inputs<br>(Level 3) |
|--|---|
| Balance at May 1, 2014   | \$ 7,297  |
| Transfers to Level 3   |   |
| Total gains (realized or unrealized)   |   |
| Included in earnings   |   |
| Included in other comprehensive loss   | (1,161)   |
| Purchases, issuances and settlements, net  | (3,375)   |
| Balance at November 1, 2014  | \$ 2,761  |
| The amount of total gains or (losses) for the period included in earnings (or change in net assets) attributable to the change in unrealized gains or losses relating to assets still held at November 1, 2014 | \$  |

The auction rate securities are valued using a discounted cash flow model. The analysis considers, among other items, the collateralization underlying the security investments, the creditworthiness of the counterparty, the timing of expected future cash flows, and the estimated date upon which the security is expected to have a successful auction. As of November 1, 2014, the inputs used in the Company's discounted cash flow analysis included current coupon rates of 0.08% to 0.09%, estimated redemption periods of 5 to 20 years and discount rates of 4.9% to 19.2%. The discount rates were based on market rates for municipal bond securities, as adjusted for a risk premium to reflect the lack of liquidity of these investments.

Table of Contents**AeroVironment, Inc.****Notes to Consolidated Financial Statements (Unaudited)****4. Inventories, net**

Inventories consist of the following (in thousands):

|                                    | <b>November 1,<br/>2014</b> | <b>April 30,<br/>2014</b> |
|------------------------------------|-----------------------------|---------------------------|
| Raw materials                      | \$ 14,973                   | \$ 15,102                 |
| Work in process                    | 5,604                       | 7,542                     |
| Finished goods                     | 34,296                      | 31,289                    |
| Inventories, gross                 | 54,873                      | 53,933                    |
| Reserve for inventory obsolescence | (3,069)                     | (3,234)                   |
| Inventories, net                   | \$ 51,804                   | \$ 50,699                 |

**5. Warranty Reserves**

The Company accrues an estimate of its exposure to warranty claims based upon both current and historical product sales data and warranty costs incurred. The warranty reserve is included in other current liabilities. The related expense is included in cost of sales. Warranty reserve activity is summarized as follows for the three and six months ended November 1, 2014 and October 26, 2013 (in thousands):

|                         | <b>Three Months Ended</b>   |                             | <b>Six Months Ended</b>     |                             |
|-------------------------|-----------------------------|-----------------------------|-----------------------------|-----------------------------|
|                         | <b>November 1,<br/>2014</b> | <b>October 26,<br/>2013</b> | <b>November 1,<br/>2014</b> | <b>October 26,<br/>2013</b> |
| Beginning balance       | \$ 1,273                    | \$ 1,691                    | \$ 1,280                    | \$ 1,515                    |
| Warranty expense        | 1,027                       | 332                         | 1,409                       | 818                         |
| Warranty claims settled | (341)                       | (383)                       | (730)                       | (693)                       |
| Ending balance          | \$ 1,959                    | \$ 1,640                    | \$ 1,959                    | \$ 1,640                    |

**6. Accumulated Other Comprehensive Loss**

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

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|                                | Available-for-Sale<br>Securities |       | Accumulated Other<br>Comprehensive Loss |       |
|--------------------------------|----------------------------------|-------|---|-------|
| Balance as of April 30, 2014   | \$                               | (263) | \$                                      | (263) |
| Unrealized loss                |                                  | (993) |   | (993) |
| Income taxes                   |                                  | 397   |   | 397   |
| Balance as of November 1, 2014 | \$                               | (859) | \$                                      | (859) |

**7. Customer-Funded Research & Development**

Customer-funded R&D costs are incurred pursuant to contracts (revenue arrangements) to perform R&D activities according to customer specifications. These costs are direct contract costs and are expensed to cost of sales when the corresponding revenue is recognized, which is generally as the R&D services are performed. Revenue from customer-funded R&D was approximately \$5.6 million and \$9.9 million for the three and six months ended November 1, 2014, respectively. Revenue from customer-funded R&D was approximately \$6.6 million and \$16.9 million for the three and six months ended October 26, 2013, respectively.



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**AeroVironment, Inc.**

**Notes to Consolidated Financial Statements (Unaudited)**

**8. Restructuring Charges**

During the three and six months ended October 26, 2013, the Company recorded restructuring charges consisting primarily of severance charges of \$0.7 million and \$1.8 million, respectively. During the three months ended October 26, 2013, \$0.7 million in restructuring charges were recorded in cost of sales, all of which were related to the Unmanned Aircraft Systems ( UAS ) segment. During the six months ended October 26, 2013, \$1.7 million in restructuring charges were recorded in cost of sales, of which \$1.4 million was related to UAS and \$0.3 million was related to the Efficient Energy Systems ( EES ) business segment. During the six months ended October 26, 2013, \$0.1 million in restructuring charges were recorded in selling, general and administrative costs. The Company does not report SG&A costs by segment as the CODM only reviews the revenue and gross margin results for each of these segments when making resource allocation decisions.

The purpose of the organizational realignment and workforce reduction on May 29, 2013, within the Company's UAS and EES business segments, was to enhance the Company's focus on new product introductions and the adoption of new solutions designed to support the Company's long-term growth plans. The workforce reduction was necessitated by continuing delays in U.S. government procurements from the Company's UAS business segment and delays in the growth of plug-in electric vehicle adoption and associated recharging solution sales in the Company's EES business segment.

The purpose of the organizational realignment and workforce reduction on September 26, 2013, within the Company's UAS business segment, was to address shifts in the UAS segment's business mix and align the skills within the UAS business segment more closely with market requirements to support ongoing programs and emerging growth opportunities.

**9. Income Taxes**

For the three and six months ended November 1, 2014, the Company recorded a benefit for income taxes of \$1.6 million and \$3.7 million, respectively, yielding an effective tax benefit rate of 35.8% and 36.1%, respectively. For the three and six months ended October 26, 2013, the Company recorded a provision (benefit) for income taxes of \$0.2 million and \$(2.9) million, respectively, yielding an effective tax rate of 9.1% and 34.4%, respectively. The variance from statutory tax rates for the three months ended October 26, 2013 was primarily due to federal research and development tax credits.

Table of Contents**AeroVironment, Inc.****Notes to Consolidated Financial Statements (Unaudited)****10. Segment Data**

The Company's product segments are as follows:

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

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

|                                     | Three Months Ended  |                     | Six Months Ended    |                     |
|-------------------------------------|---------------------|---------------------|---------------------|---------------------|
|                                     | November 1,<br>2014 | October 26,<br>2013 | November 1,<br>2014 | October 26,<br>2013 |
| <b>Revenue:</b>                     |                     |                     |                     |                     |
| UAS                                 | \$ 43,045           | \$ 56,079           | \$ 84,231           | \$ 91,290           |
| EES                                 | 9,619               | 8,788               | 20,299              | 17,694              |
| Total                               | 52,664              | 64,867              | 104,530             | 108,984             |
| <b>Cost of sales:</b>               |                     |                     |                     |                     |
| UAS                                 | 27,575              | 35,280              | 58,590              | 59,879              |
| EES                                 | 7,218               | 5,709               | 14,015              | 12,682              |
| Total                               | 34,793              | 40,989              | 72,605              | 72,561              |
| <b>Gross margin:</b>                |                     |                     |                     |                     |
| UAS                                 | 15,470              | 20,799              | 25,641              | 31,411              |
| EES                                 | 2,401               | 3,079               | 6,284               | 5,012               |
| Total                               | 17,871              | 23,878              | 31,925              | 36,423              |
| Selling, general and administrative | 13,470              | 13,084              | 26,873              | 25,543              |
| Research and development            | 8,531               | 6,861               | 15,655              | 14,051              |
| (Loss) income from operations       | (4,130)             | 3,933               | (10,603)            | (3,171)             |
| Other income (expense):             |                     |                     |                     |                     |

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|                                   |            |          |             |            |
|-----------------------------------|------------|----------|-------------|------------|
| Interest income                   | 193        | 195      | 405         | 400        |
| Other (expense) income            | (583)      | (2,307)  | 8           | (5,701)    |
| (Loss) income before income taxes | \$ (4,520) | \$ 1,821 | \$ (10,190) | \$ (8,472) |

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

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

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

**Critical Accounting Policies and Estimates**

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

There have been no material changes made to the critical accounting estimates during the periods presented in the consolidated financial statements from those disclosed in the Form 10-K for the fiscal year ended April 30, 2014.

We review cost performance and estimates to complete at least quarterly and in many cases more frequently. Adjustments to original estimates for a contract's revenue, estimated costs at completion and estimated profit or loss are often required as work progresses under a contract, as experience is gained and as more information is obtained, even though the scope of work required under the contract may not change, or if contract modifications occur. The impact of revisions in profit estimates for all types of contracts are recognized on a cumulative catch-up basis in the period in which the revisions are made. During the three and six months ended November 1, 2014 and October 26, 2013, changes in accounting estimates on fixed-price contracts recognized using the percentage of completion method of accounting are presented below.

For the three months ended November 1, 2014 and October 26, 2013, favorable and unfavorable cumulative catch-up adjustments included in cost of sales were as follows (in thousands):

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|                               | Three Months Ended  |                     |
|-------------------------------|---------------------|---------------------|
|                               | November 1,<br>2014 | October 26,<br>2013 |
| Gross favorable adjustments   | \$ 710              | \$ 382              |
| Gross unfavorable adjustments | (796)               | (572)               |
| Net unfavorable adjustments   | \$ (86)             | \$ (190)            |

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

For the three months ended October 26, 2013, favorable cumulative catch-up adjustments of \$0.4 million were primarily due to final cost adjustments on seven contracts, which individually were not material. For the same period, unfavorable cumulative catch-up adjustments of \$0.6 million were primarily related to higher than expected costs on 43 contracts, which individually were not material.

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For the six months ended November 1, 2014 and October 26, 2013, favorable and unfavorable cumulative catch-up adjustments included in cost of sales were as follows (in thousands):

|                               | Six Months Ended    |                     |
|-------------------------------|---------------------|---------------------|
|                               | November 1,<br>2014 | October 26,<br>2013 |
| Gross favorable adjustments   | \$ 991              | \$ 587              |
| Gross unfavorable adjustments | (1,156)             | (1,113)             |
| Net unfavorable adjustments   | \$ (165)            | \$ (526)            |

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

For the six months ended October 26, 2013, favorable cumulative catch-up adjustments of \$0.6 million were primarily due to final cost adjustments on 27 contracts, which individually were not material. For the same period, unfavorable cumulative catch-up adjustments of \$1.1 million were primarily related to higher than expected costs on 32 contracts, which individually were not material.

### **Fiscal Periods**

Due to our fixed year end date of April 30, our first and fourth quarters each consist of approximately 13 weeks. The second and third quarters each consist of exactly 13 weeks. Our first three quarters end on a Saturday. Our 2015 fiscal year ends on April 30, 2015 and our fiscal quarters end on August 2, 2014, November 1, 2014 and January 31, 2015.

### **Results of Operations**

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

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

### ***Three Months Ended November 1, 2014 Compared to Three Months Ended October 26, 2013***

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|                                     | Three Months Ended  |                     |
|-------------------------------------|---------------------|---------------------|
|                                     | November 1,<br>2014 | October 26,<br>2013 |
| <b>Revenue:</b>                     |                     |                     |
| UAS                                 | \$ 43,045           | \$ 56,079           |
| EES                                 | 9,619               | 8,788               |
| Total                               | 52,664              | 64,867              |
| <b>Cost of sales:</b>               |                     |                     |
| UAS                                 | 27,575              | 35,280              |
| EES                                 | 7,218               | 5,709               |
| Total                               | 34,793              | 40,989              |
| <b>Gross margin:</b>                |                     |                     |
| UAS                                 | 15,470              | 20,799              |
| EES                                 | 2,401               | 3,079               |
| Total                               | 17,871              | 23,878              |
| Selling, general and administrative | 13,470              | 13,084              |
| Research and development            | 8,531               | 6,861               |
| (Loss) income from operations       | (4,130)             | 3,933               |
| <b>Other income (expense):</b>      |                     |                     |
| Interest income                     | 193                 | 195                 |
| Other expense                       | (583)               | (2,307)             |
| (Loss) income before income taxes   | \$ (4,520)          | \$ 1,821            |

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**Revenue.** Revenue for the three months ended November 1, 2014 was \$52.7 million, as compared to \$64.9 million for the three months ended October 26, 2013, representing a decrease of \$12.2 million, or 19%. The decrease in revenue was due to a decrease in product deliveries of \$8.7 million and lower service revenue of \$3.6 million. UAS revenue decreased \$13.0 million, or 23%, to \$43.0 million for the three months ended November 1, 2014, primarily due to lower product deliveries of \$10 million, a decrease in service revenue of \$2.1 million, and lower customer-funded R&D work of \$1.0 million. The decrease in product deliveries was primarily due to lower small UAS product deliveries. The decrease in service revenue was primarily due to reduced repair activities for our small UAS. The decrease in customer-funded R&D was primarily due to a decrease in Switchblade-related customer funded R&D work. EES revenue increased \$0.8 million, or 9%, to \$9.6 million for the three months ended November 1, 2014, primarily due to increased product deliveries of our passenger electric vehicle charging systems.

**Cost of Sales.** Cost of sales for the three months ended November 1, 2014 was \$34.8 million, as compared to \$41.0 million for the three months ended October 26, 2013, representing a decrease of \$6.2 million, or 15%. Cost of sales was impacted by a government contract accounting reserve of \$2.6 million recorded in the quarter for prior year incurred cost audit findings. As a percentage of revenue, cost of sales increased from 63% to 66%. The decrease in cost of sales was primarily due to lower product costs of \$4.4 million due to lower product deliveries and lower cost of services of \$1.8 million primarily due to a reduction in repair activities and lower customer-funded R&D work. UAS cost of sales decreased \$7.7 million, or 22%, to \$27.6 million for the three months ended November 1, 2014, primarily due to a decrease in sales volume. As a percentage of revenue, cost of sales for UAS increased from 63% to 64%. EES cost of sales increased \$1.5 million, or 26%, to \$7.2 million for the three months ended November 1, 2014. As a percentage of revenue, cost of sales for EES increased from 65% to 75%, primarily due to unfavorable product mix.

**Gross Margin.** Gross margin for the three months ended November 1, 2014 was \$17.9 million, as compared to \$23.9 million for the three months ended October 26, 2013, representing a decrease of \$6.0 million, or 25%. The decrease in gross margin was due to lower product margins of \$4.3 million and lower service margins of \$1.7 million. As a percentage of revenue, gross margin decreased from 37% to 34%. UAS gross margin decreased \$5.3 million, or 26%, to \$15.5 million for the three months ended November 1, 2014. The decrease was primarily due to lower sales volume. As a percentage of revenue, gross margin for UAS decreased from 37% to 36%. EES gross margin decreased \$0.7 million, or 22%, to \$2.4 million for the three months ended November 1, 2014, primarily due to an unfavorable product mix. As a percentage of revenue, EES gross margin decreased from 35% to 25%, primarily due to an unfavorable product mix.

**Selling, General and Administrative.** SG&A expense for the three months ended November 1, 2014 was \$13.5 million, or 26% of revenue, compared to SG&A expense of \$13.1 million, or 20% of revenue, for the three months ended October 26, 2013.

**Research and Development.** R&D expense for the three months ended November 1, 2014 was \$8.5 million, or 16% of revenue, compared to R&D expense of \$6.9 million, or 11% of revenue, for the three months ended October 26, 2013. R&D expense increased by \$1.6 million for the three months ended November 1, 2014, primarily due to increased development activities in various strategic initiatives.

**Interest Income.** Interest income for the three months ended November 1, 2014 was \$0.2 million, reflecting no change from the three months ended October 26, 2013.

**Other Expense.** Other expense for the three months ended November 1, 2014 was \$0.6 million compared to other expense of \$2.3 million for the three months ended October 26, 2013. The decrease in other expense reflects the change in fair value of the embedded conversion feature of our convertible bond investment.



**Income Taxes.** Our effective income tax benefit rate was 35.8% for the three months ended November 1, 2014, as compared to an effective income tax expense rate of 9.1% for the three months ended October 26, 2013. The change in the rate is due to lower taxable income and lower federal R&D tax credits.

Table of Contents*Six Months Ended November 1, 2014 Compared to Six Months Ended October 26, 2013*

|                                     | Six Months Ended    |                     |
|-------------------------------------|---------------------|---------------------|
|                                     | November 1,<br>2014 | October 26,<br>2013 |
| <b>Revenue:</b>                     |                     |                     |
| UAS                                 | \$ 84,231           | \$ 91,290           |
| EES                                 | 20,299              | 17,694              |
| Total                               | 104,530             | 108,984             |
| <b>Cost of sales:</b>               |                     |                     |
| UAS                                 | 58,590              | 59,879              |
| EES                                 | 14,015              | 12,682              |
| Total                               | 72,605              | 72,561              |
| <b>Gross margin:</b>                |                     |                     |
| UAS                                 | 25,641              | 31,411              |
| EES                                 | 6,284               | 5,012               |
| Total                               | 31,925              | 36,423              |
| Selling, general and administrative | 26,873              | 25,543              |
| Research and development            | 15,655              | 14,051              |
| Loss from operations                | (10,603)            | (3,171)             |
| <b>Other income (expense):</b>      |                     |                     |
| Interest income                     | 405                 | 400                 |
| Other income (expense)              | 8                   | (5,701)             |
| Loss before income taxes            | \$ (10,190)         | \$ (8,472)          |

**Revenue.** Revenue for the six months ended November 1, 2014 was \$104.5 million, as compared to \$109.0 million for the six months ended October 26, 2013, representing a decrease of \$4.5 million, or 4%. The decrease in revenue was due to lower service revenue of \$11.5 million, offset by higher product deliveries of \$7.0 million. UAS revenue decreased \$7.1 million, or 8%, to \$84.2 million for the six months ended November 1, 2014, primarily due to decreases in customer-funded R&D work of \$7.0 million and service revenue of \$3.6 million, offset by higher product deliveries of \$3.5 million. The decrease in customer-funded R&D was primarily due to a decrease in development programs related to our small UAS and no revenue related to the Global Observer program termination cost reimbursement. The decrease in service revenue was primarily due to reduced repair activities for our small UAS. The increase in product deliveries was primarily due to higher product deliveries of Switchblade systems. EES revenue increased \$2.6 million, or 15%, to \$20.3 million for the six months ended November 1, 2014, primarily due to increased product deliveries of our industrial fast charge systems partially offset by lower product deliveries of our passenger electric vehicle charging systems as the California Energy Commission program came to an end earlier this year.

**Cost of Sales.** Cost of sales for the six months ended November 1, 2014 and October 26, 2013 remained at \$72.6 million. Cost of sales was impacted by a government contract accounting reserve of \$2.6 million recorded in the quarter for prior year incurred cost audit findings. As a percentage of revenue, cost of sales increased from 67% to 69%. Services cost of sales was lower by \$5.8 million primarily due to lower customer-funded R&D work as Switchblade transitioned into low-rate production and a reduction in repair activities, offset by higher product costs of \$5.8 million due to higher product deliveries. UAS cost of sales decreased \$1.3 million, or 2%, to \$58.6 million for the six months ended November 1, 2014, primarily due to a decrease in sales volume. As a percentage of revenue, cost of sales for UAS increased from 66% to 70%. EES cost of sales increased \$1.3 million, or 11%, to \$14.0 million for the six months ended November 1, 2014. As a percentage of revenue, cost of sales for EES decreased from 72% to 69% primarily due to a favorable product mix.

**Gross Margin.** Gross margin for the six months ended November 1, 2014 was \$31.9 million, as compared to \$36.4 million for the six months ended October 26, 2013, representing a decrease of \$4.5 million, or 12%. The decrease in gross margin was due to lower service margins of \$5.6 million, offset by higher product margins of \$1.1 million. As a percentage of revenue, gross margin decreased from 33% to 31%. UAS

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gross margin decreased \$5.8 million, or 18%, to \$25.6 million for the six months ended November 1, 2014. The decrease was primarily due to a termination settlement for our Global Observer Joint Capability Technology Demonstration contract that occurred during the six months ended October 26, 2013 that was not in the six months ended November 1, 2014, and lower margins on service-related contracts. As a percentage of revenue, gross margin for UAS decreased from 34% to 30%. EES gross margin increased \$1.3 million, or 25%, to \$6.3 million for the six months ended November 1, 2014, primarily due to higher sales volume and favorable product mix. As a percentage of revenue, EES gross margin increased from 28% to 31%, primarily due to a favorable product mix.

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**Selling, General and Administrative.** SG&A expense for the six months ended November 1, 2014 was \$26.9 million, or 26% of revenue, compared to SG&A expense of \$25.5 million, or 23% of revenue, for the six months ended October 26, 2013. SG&A expense increased by \$1.3 million for the six months ended November 1, 2014, primarily due to higher proposal and business development activity.

**Research and Development.** R&D expense for the six months ended November 1, 2014 was \$15.7 million, or 15% of revenue, compared to R&D expense of \$14.1 million, or 13% of revenue, for the six months ended October 26, 2013. R&D expense increased by \$1.6 million for the six months ended November 1, 2014, primarily due to increased development activities with the Switchblade program and other small UAS initiatives.

**Interest Income.** Interest income for the six months ended November 1, 2014 was \$0.4 million, reflecting no change from the six months ended October 26, 2013.

**Other Income.** Other income for the six months ended November 1, 2014 was \$8,000, as compared to other expense of \$5.7 million for the six months ended October 26, 2013. During the six months ended October 26, 2013, the increase in other expense was related to the conversion feature of two convertible bonds that decreased in value. During the six months ended November 1, 2014, there was only one bond outstanding, which was converted into equity securities on August 11, 2014.

**Income Tax Benefit.** Our effective income tax benefit rate was 36.1% for the six months ended November 1, 2014, as compared to an effective income benefit tax rate of 34.4% for the six months ended October 26, 2013.

**Backlog**

We define funded backlog as unfilled firm orders for products and services for which funding currently is appropriated to us under the contract by the customer. As of November 1, 2014 and April 30, 2014, our funded backlog was approximately \$125.2 million and \$65.9 million, respectively.

In addition to our funded backlog, we also had unfunded backlog of \$32.4 million and \$22.9 million as of November 1, 2014 and April 30, 2014, respectively. We define unfunded backlog as the total remaining potential order amounts under cost reimbursable and fixed price contracts with multiple one-year options, and indefinite delivery, indefinite quantity, or IDIQ contracts. Unfunded backlog does not obligate the U.S. government to purchase goods or services. There can be no assurance that unfunded backlog will result in any orders in any particular period, if at all. Management believes that unfunded backlog does not provide a reliable measure of future estimated revenue under our contracts. Unfunded backlog does not include the remaining potential value associated with a U.S. Army IDIQ-type contract for small UAS because the contract was awarded to five companies in 2012, including AeroVironment, and we cannot be certain that we will receive task orders issued against the contract.

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

Table of Contents**Liquidity and Capital Resources**

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

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

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

**Cash Flows**

The following table provides our cash flow data for the six months ended November 1, 2014 and October 26, 2013 (in thousands):

|   | Six Months Ended    |                     |
|---|---------------------|---------------------|
|   | November 1,<br>2014 | October 26,<br>2013 |
|   | (Unaudited)         |                     |
| Net cash provided by (used in) operating activities | \$ 9,961            | \$ (9,673)          |
| Net cash (used in) provided by investing activities | \$ (11,618)         | \$ 312              |
| Net cash provided by financing activities           | \$ 1,027            | \$ 155              |

**Cash Provided by (Used in) Operating Activities.** Net cash provided by operating activities for the six months ended November 1, 2014, increased by \$19.6 million to \$10.0 million, compared to net cash used in operating activities of \$9.7 million for the six months ended October 26, 2013. The increase in net cash provided by operating activities was primarily due to lower working capital needs of \$27.4 million, partially offset by an increase in fair value of the embedded conversion feature of our convertible bond investment of \$5.8 million and a higher

net loss of \$1.0 million.

**Cash (Used in) Provided by Investing Activities.** Net cash used in investing activities increased by \$11.9 million to \$11.6 million for the six months ended November 1, 2014, compared to net cash provided by investing activities of \$0.3 million for the six months ended October 26, 2013. The increase in net cash used in investing activities was primarily due to an increase in net purchases of investments of \$17.7 million offset by lower acquisitions of property and equipment of \$5.0 million.

**Cash Provided by Financing Activities.** Net cash provided by financing activities was \$1.0 million for the six months ended November 1, 2014, compared to net cash provided by financing activities of \$0.2 million for the six months ended October 26, 2013. The increase was due to an increase in cash received from exercises of stock options of \$0.5 million and higher excess tax benefits of \$0.3 million.

#### **Off-Balance Sheet Arrangements**

During the second quarter, there were no material changes in our off-balance sheet arrangements or contractual obligations and commercial commitments from those disclosed in the Form 10-K for the fiscal year ended April 30, 2014.

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**Inflation**

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

**New Accounting Standards**

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

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

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

*Interest Rate Risk*

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

*Foreign Currency Exchange Rate Risk*

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

**ITEM 4. CONTROLS AND PROCEDURES**

*Controls and Procedures*



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

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

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

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

***Internal Control over Financial Reporting***

There were no changes in our internal control over financial reporting or in other factors identified in connection with the evaluation required by paragraph (d) of Exchange Act Rules 13a-15 or 15d-15 that occurred during the quarter ended November 1, 2014 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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**PART II. OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

We are, from time to time, party to a variety of legal proceedings arising in the ordinary course of business, including lawsuits, investigations and other governmental proceedings, audits and reviews. While the results of legal proceedings cannot be predicted with certainty, management believes that the final outcome of these proceedings will not have a material adverse effect on our financial condition taken as a whole.

**ITEM 1A. RISK FACTORS**

There have been no material changes to the risk factors disclosed under Part I, Item 1A, Risk Factors, in our Annual Report on Form 10-K for the fiscal year ended April 30, 2014. Please refer to that section for disclosures regarding the risks and uncertainties related to our business.

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

None.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

**ITEM 4. MINE SAFETY DISCLOSURES**

None.

**ITEM 5. OTHER INFORMATION**

None.

**ITEM 6. EXHIBITS**

| <b>Exhibit<br/>Number</b> | <b>Description</b>   |
|---------------------------|--|
| 31.1                      | Certification of Chief Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended.                                     |
| 31.2                      | Certification of Chief Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended.                                     |
| 32                        | Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 101.INS                   | XBRL Instance Document.  |
| 101.SCH                   | XBRL Taxonomy Extension Schema Document.   |
| 101.CAL                   | XBRL Taxonomy Calculation Linkbase Document.   |
| 101.DEF                   | XBRL Taxonomy Extension Definition Linkbase Document.  |
| 101.LAB                   | XBRL Taxonomy Label Linkbase Document.   |
| 101.PRE                   | XBRL Taxonomy Presentation Linkbase Document.  |

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**SIGNATURES**

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

Date: November 25, 2014

AEROVIRONMENT, INC.

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

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