

73-4460 Queen Kaahumanu Hwy. #102, Kailua-Kona, HI 96740

(Address of principal executive offices)

(808) 326-1353

(Registrant's telephone number)

Not Applicable

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

Indicate by check mark whether the registrant (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act of 1934 during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes 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 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

Smaller reporting company

(Do not check if a smaller reporting company)

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

Number of common shares outstanding as of August 11, 2014:

Title of Class	Shares Outstanding
Common stock - \$0.02 par value	5,488,038

CYANOTECH CORPORATION

FORM 10-Q

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PART 1. FINANCIAL INFORMATION

Item 1. Financial Statements (Unaudited)

CYANOTECH CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

(Dollars in thousands except par value and number of shares)

(Unaudited)

	June 30, 2014	March 31, 2014
ASSETS		
Current assets:		
Cash and cash equivalents	\$3,393	\$4,312
Accounts receivable, net of allowance for doubtful accounts of \$6 at June 30, 2014 and \$6 at March 31, 2014	3,064	3,347
Inventories, net	4,818	4,876
Deferred tax assets	216	216
Prepaid expenses and other current assets	397	339
Total current assets	11,888	13,090
Equipment and leasehold improvements, net	12,417	11,826
Restricted cash	1,115	1,368
Deferred tax assets	3,875	3,124
Other assets	882	902
Total assets	\$30,177	\$30,310
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Current maturities of long-term debt	\$210	\$204
Customer deposits	63	30
Accounts payable	3,284	3,184
Accrued expenses	779	774
Total current liabilities	4,336	4,192
Long-term debt, excluding current maturities	5,206	5,263
Deferred rent	8	8
Total liabilities	9,550	9,463

Commitments and contingencies

Stockholders' equity:

Common stock of \$0.02 par value, shares authorized 50,000,000; 5,488,038 shares issued and outstanding at June 30, 2014 and 5,488,038 at March 31, 2014	110	110
Additional paid-in capital	30,084	29,891
Accumulated deficit	(9,567)	(9,154)
Total stockholders' equity	20,627	20,847
Total liabilities and stockholders' equity	\$30,177	\$30,310

See accompanying Notes to Condensed Consolidated Financial Statements.

CYANOTECH CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Dollars in thousands, except per share amounts)

(Unaudited)

	Three Months Ended June 30,	
	2014	2013
NET SALES	\$7,442	\$6,909
COST OF SALES	4,474	4,057
Gross Profit	2,968	2,852
OPERATING EXPENSES:		
General and administrative	2,747	1,556
Sales and marketing	1,234	1,004
Research and development	116	115
Loss on disposal of equipment and leasehold improvements	10	5
Total operating expenses	4,107	2,680
Income (loss) from operations	(1,139)	172
Interest expense, net	25	36
Income (loss) before income tax	(1,164)	136
INCOME TAX EXPENSE (BENEFIT)	(751)	106
NET INCOME (LOSS)	\$(413)	\$30
NET INCOME (LOSS) PER SHARE:		
Basic	\$(0.08)	\$0.01
Diluted	\$(0.08)	\$0.01
SHARES USED IN CALCULATION OF NET INCOME (LOSS) PER SHARE:		
Basic	5,488	5,464
Diluted	5,488	5,615

See accompanying Notes to Condensed Consolidated Financial Statements.

CYANOTECH CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in thousands)

(Unaudited)

	Three Months Ended June 30, 2014 2013	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income (loss)	\$(413)	\$30
Adjustments to reconcile net income (loss) to net cash used in operating activities:		
Loss on disposal of equipment and leasehold improvements	10	5
Depreciation and amortization	303	240
Amortization of debt issue costs and other assets	12	10
Share based compensation expense	192	178
Reduction of inventory reserve	(1)	(1)
Deferred income tax provision (benefit)	(751)	106
Net (increase) decrease in assets:		
Accounts receivable	283	(130)
Inventories	59	(523)
Prepaid expenses and other assets	(50)	(438)
Net increase (decrease) in liabilities:		
Customer deposits	33	(4)
Accounts payable	100	357
Accrued expenses	5	(121)
Net cash used in operating activities	(218)	(291)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Proceeds from restricted cash	253	644
Investment in equipment and leasehold improvements	(903)	(1,611)
Net cash used in investing activities	(650)	(967)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Principal payments on long-term debt	(51)	(8)
Proceeds from stock options exercised	—	6
Net cash used in financing activities	(51)	(2)
Net decrease in cash and cash equivalents	(919)	(1,260)
Cash and cash equivalents at beginning of period	4,312	4,364

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Cash and cash equivalents at end of period	\$3,393	\$3,104
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SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:

Cash paid during the period for:

Interest	\$75	\$75
Income taxes	\$—	\$5

See accompanying Notes to Condensed Consolidated Financial Statements.

CYANOTECH CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2014
(Unaudited)

1. BASIS OF PRESENTATION

The accompanying condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) for interim financial information pursuant to the instructions to Form 10-Q and Regulation S-X of the Securities and Exchange Commission (SEC). These interim condensed consolidated financial statements are unaudited and, in the opinion of management, include all adjustments (consisting of normal recurring adjustments and accruals) necessary to present fairly the Condensed Consolidated Balance Sheets, Condensed Consolidated Statements of Operations, and Condensed Consolidated Statements of Cash Flows for the periods presented in accordance with GAAP. Accordingly, they do not include all of the information and notes required by GAAP for complete financial statements. The results of operations for the interim periods are not necessarily indicative of the results to be expected for the full fiscal year. The Condensed Consolidated Balance Sheet as of March 31, 2014 was derived from the audited financial statements. These condensed consolidated financial statements and notes should be read in conjunction with the Company’s audited consolidated financial statements for the year ended March 31, 2014, contained in the Company’s annual report on Form 10-K as filed with the SEC on June 27, 2014.

The accompanying condensed consolidated financial statements include the accounts of Cyanotech Corporation and its wholly owned subsidiary, Nutrex Hawaii, Inc. (“Nutrex Hawaii” or “Nutrex”, collectively the “Company”). All significant intercompany balances and transactions have been eliminated in consolidation.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosures of any contingent assets and liabilities as of the date of the financial statements and the reported amounts of revenues and expenses during the periods reported. Management reviews these estimates and assumptions periodically and reflects the effect of revisions in the period that they are determined to be necessary. Actual results could differ from those estimates and assumptions.

Recent Accounting Pronouncements

In May 2014, the FASB issued ASU 2014-09, "Revenue from Contracts with Customers", which will supersede most existing U.S.GAAP revenue recognition guidance. This new standard requires an entity to recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration to which an entity expects to be entitled in exchange for those goods or services. In addition, ASU 2014-09 contains expanded disclosure requirements relating to the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. ASU 2014-09 is effective for fiscal periods beginning after December 15, 2016 and permits the use of either the full retrospective or cumulative effect transition method. Early adoption is not permitted. We have not yet selected a transition method and are evaluating the impact that this new standard will have on our consolidated financial statements.

2. INVENTORIES

Inventories are stated at the lower of cost or market. Cost is determined by the first-in, first-out method. Inventories consist of the following:

	June 30, 2014	March 31, 2014
	(in thousands)	
Raw materials	\$907	\$1,411
Work in process	284	337
Finished goods (1)	3,340	2,847
Supplies	287	281
	\$4,818	\$4,876

(1) Net of reserve for obsolescence of \$5,000 and \$6,000, at June 30, 2014 and March 31, 2014, respectively.

The Company recognizes abnormal production costs, including fixed cost variances from normal production capacity, as an expense in the period incurred. Abnormal production costs of \$64,000 and non-inventoriable fixed costs of \$17,000 were charged to cost of sales for the quarter ended June 30, 2014. There were no non-inventoriable or abnormal production costs charged to cost of sales for the quarter ended June 30, 2013.

3. 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, or the shorter of the land lease term or estimated useful lives for leasehold improvements as follows:

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

Equipment and leasehold improvements consist of the following:

	June 30, 2014	March 31, 2014
	(in thousands)	
Equipment	\$8,936	\$8,840
Leasehold improvements	9,833	9,756
Furniture and fixtures	297	291
	19,066	18,887
Less accumulated depreciation and amortization	(11,655)	(11,393)
Construction-in-progress	5,006	4,332
Equipment and leasehold improvements, net	\$12,417	\$11,826

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. Recoverability of these assets is measured by a comparison of the carrying amount to forecasted undiscounted future cash flows expected to be generated by the asset. If the carrying amount exceeds its estimated future cash flows, then an impairment charge is recognized to the extent that the carrying amount exceeds the asset's fair value. Management has determined no asset impairment existed as of June 30, 2014. The Company recognized a loss on disposal of equipment in the amount of \$10,000 for the three months ended June 30, 2014. The Company recognized a loss on disposal of equipment in the amount of \$5,000 for the three months ended June 30, 2013.

The Company has capitalized \$55,000 of interest for the three months ended June 30, 2014. \$43,000 was capitalized for the three months ended June 30, 2013.

4. ACCRUED EXPENSES

Accrued expenses consist of the following:

	June 30, 2014	March 31, 2014
	(in thousands)	
Wages and profit sharing	\$474	\$ 582
Customer rebates	84	55
Other accrued expenses	221	137
	\$779	\$ 774

5. LONG-TERM DEBT

Long-term debt consists of the following:

	June 30, 2014	March 31, 2014
	(in thousands)	
Term loans	\$5,416	\$5,467
Less current maturities	(210)	(204)
Long-term debt, excluding current maturities	\$5,206	\$5,263

Term Loan Agreements

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, 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 United States Department of Agriculture (“USDA”) Rural Development Guarantee program (the “Guarantees”). The proceeds of the Loan will be used to acquire new processing equipment and leasehold improvements at its Kona, Hawaii facility.

The provisions of the Loan require 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 (3.25% at June 30, 2014) 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 \$5,371,000 at June 30, 2014. Proceeds from the Loan are classified as restricted cash until drawn upon to acquire new processing equipment and leasehold improvements.

The Loan includes a one-time origination and guaranty fee 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 was in compliance with these financial covenants at June 30, 2014.

The Company has three equipment loans with John Deere credit providing for \$103,000 in equipment financing; these loans are payable in 48 equal monthly principal payments. At June 30, 2014 and March 31, 2014, the total outstanding combined balance was approximately \$36,000 and \$42,000, respectively. The equipment loans mature at various dates between May 2015 and June 2016. The loans are at a 0% rate of interest and are net of unamortized discount of \$1,000 and \$1,000 at June 30, 2014 and March 31, 2014, respectively.

In September 2011, the Company executed a Term Loan Agreement with Nissan Motor Acceptance Corporation providing for \$23,000 in equipment financing, secured by the equipment. The Term Loan has a maturity date of September 13, 2016 and is payable in 60 equal monthly principal payments. The interest rate under this Term Loan is 0%. Imputed interest at a rate of 2% (cash discount offered by seller) has been recorded and is being amortized as interest over the term of the loan. The balance outstanding under the Term Loan was \$10,000 and \$12,000 at June 30, 2014 and March 31, 2014, respectively, less the unamortized discount of \$200 and \$300 at June 30, 2014 and March 31, 2014, respectively.

Future principal payments under the term loan and capital lease agreements as of June 30, 2014 are as follows:

Payments Due	(in thousands)
Next 12 Months	\$ 210
Year 2	206
Year 3	203
Year 4	213
Year 5	225
Thereafter	4,359
Total principal payments	\$ 5,416

6. LEASES

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. Management has accrued for the estimated contingent rent as of June 30, 2014.

Future minimum lease payments under all non-cancelable operating leases at June 30, 2014 are as follows:

Payments Due	(in thousands)
Next 12 Months	\$ 498
Year 2	408
Year 3	408
Year 4	401
Year 5	403
Thereafter	5,025
Total minimum lease payments	\$ 7,143

7. COMMITMENTS AND CONTINGENCIES

On September 12, 2012, the Company entered into an agreement with ThyssenKrupp Industrial Solutions (USA), Inc. ("TKIS"), formerly Uhde Corporation of America, for the purchase of supercritical carbon dioxide extraction equipment to be used in the processing of its natural astaxanthin ("Equipment"). Pursuant to the terms of the agreement, TKIS will build, ship and provide assistance in installing the Equipment. The Equipment, which was originally scheduled for delivery approximately 14 months from the date of the agreement, is now scheduled for a delivery in the third quarter of this fiscal year. The Company will pay TKIS an aggregate of \$3,222,000 for the equipment and services, of which \$645,000 remains unpaid as of June 30, 2014. Progress payments through June 30, 2014 of \$2,577,000 have been classified in construction in progress in the consolidated balance sheet.

The Company is subject to legal proceedings and claims from time to time in the ordinary course of business. Although management cannot predict with certainty the ultimate resolution of legal proceedings and claims asserted against the Company, management does not believe that any currently pending legal proceeding to which the Company is a party is likely to have a material adverse effect on its business, results of operations, cash flows or financial condition.

We have previously disclosed the negative effect of the legal costs of one pending patent lawsuit against the Company and a related administrative proceeding initiated by the Company to challenge the validity of the patent which is the

subject of the lawsuit.¹ Our legal costs grew significantly in the first quarter of this fiscal year due to costs related to development of reports by our medical and economic experts, the extension of discovery and deposition deadlines, and costs related to preparation for the oral hearing with the Patent Trial and Appeal Board ("**PTAB**") on our *Inter Partes* Review (see *Risk Factors*, page 13-14, and discussion of increase in *Operating Expenses*, page 16).

Patent litigation and *Inter Partes* Review matters:

On June 29, 2012, U.S.Nutraceuticals LLC, d/b/a Valensa International [**"Valensa"**] and The Board of Trustees of the University of Illinois [the **"Patent Owner"**] filed a lawsuit against Cyanotech Corporation and Nutrex Hawaii, Inc. in the U.S. District Court for the Middle District of Florida, Ocala Division (the **"Litigation"**) primarily alleging infringement of U.S. patent no. 5,527,533² (the **"533 Patent"** or **"Patent"**).

In an effort by the Company to accelerate a determination of the invalidity of the '533 Patent, the Company petitioned PTAB of the U. S. Patent and Trademark Office on June 28 and 29, 2013 to conduct an administrative review of the validity of the '533 Patent, as challenged in our Petition; PTAB instituted an *Inter Partes* Review of 18 of the 27 Claims within the '533 Patent on December 19, 2013 (**"IPR"**). The Patent Owner is the respondent in the IPR.

¹ Form 10-K, Item 3 – Legal Proceedings, dated March 31, 2014 (filed June 27, 2014), Form 8-K, Item 8.01 – Other Events, dated June 30, 2013 (filed August 26, 2013); and Forms 10-Q for the quarter ended September 30, 2013 (see Item 2 – Management’s Discussion and Analysis, *Operating Expenses*, page 16); and Form 10-Q/A (filed February 14, 2014) for the quarter ended December 31, 2013 (see Item 2 – Management’s Discussion and Analysis, *Operating Expenses*, page 15).

² The "533 Patent was granted on June 16, 1996; it expires on October 27, 2014.

(a) *Factual Basis:* (i) The product involved in the Litigation and the *Inter Partes* Review is a natural health supplement called astaxanthin (“**Astaxanthin**”) which the Company grows and harvests, and in different forms markets, and sells to wholesalers, retailers and consumers. Valensa is Patent Owner’s licensee of certain rights under the ‘533 Patent and was one of the Company’s domestic wholesale customers for several years until the expiration of its supply contract with us and after it was given a 12-month notice in December 2011 that our Company would no longer sell bulk product to Valensa and to other domestic bulk customers. Valensa manufactures, markets and sells products containing Astaxanthin to wholesalers and retailers.

(ii) All Claims within the ‘533 Patent are “method of treating” claims. The ‘533 Patent is generally described in the “Field of Invention” section as a method for retarding and ameliorating certain specified diseases, injuries or damage (“condition”) by administering a therapeutically-effective amount of Astaxanthin to an individual suffering from the condition. The ‘533 Patent includes 27 Claims pertaining to: retinal damage; retinal injury; neuronal damage to a retina; age-related macular degeneration; ischemic or intraocular pressure-related disease of a retina; inflammatory disease of a retina; a free radical-induced injury to the central nervous system or comprised of a traumatic or an ischemic injury; a degenerative disease; or a degenerative central nervous system disease of a brain or spinal cord. Patent Owner and Valensa assert that all 27 Claims under the ‘533 Patent are valid. The Company asserts that all 27 Claims are invalid and therefore the entire ‘533 Patent is invalid.

(iii) Patent Owner and Valensa allege in the Litigation, but the Company denies, that the scope of the ‘533 Patent method claims extends to, and its 27 Claims apply to, our manufacturing, marketing and sales of Astaxanthin as a nutritional supplement. Patent Owner and Valensa allege, but the Company denies, that the Claims of the ‘533 Patent broadly cover “eye health,” although those particular words do not appear in the ‘533 Patent. The Company alleges that whether one or all Claims within the ‘533 Patent are determined to be valid, no Claim was infringed by any of our manufacturing, marketing or sales of Astaxanthin products and we have not induced anyone to infringe the Patent.

(b) *Relief Sought by Patent Owner and Valensa:* (i) a declaration of patent infringement; (ii) a declaration that the patent infringement was intentional; (iii) a preliminary and a permanent injunction barring us and our employees and affiliates from infringing the ‘533 Patent³; (iv) damages for infringement, plus interest and plus treble damages for willful infringement; (v) an award of attorneys’ fees and costs of suit, plus interest; and (vi) any further relief awarded by the Court.

(c) *Relief Sought by Company:* (i) a declaration of invalidity and unenforceability based on original patentability or on patent misuse; (ii) a declaration of non-infringement; (iii) a declaration of unfair competition under Hawaii law and under the Federal Lanham Act; (iv) a determination that this case is exceptional, thereby entitling the Company to recover its attorneys’ fees; (v) an award of compensatory damages to Company; (vi) an award of statutory damages under Hawaii law; (vii) an order that Patent Owner and Valensa pay over all of their unlawful profits to Company; (viii) an order to Patent Owner and Valensa to destroy all materials (e.g., advertising materials) in the possession or control of either Patent Owner and Valensa which have been determined to be false; (ix) an injunction against Patent Owner and Valensa from continuing any methods of competition declared to be in violation of Hawaii law or the Lanham Act; and (x) any further relief awarded by the Court.

The Court records of the Litigation⁴ and the filings in the *Inter Partes* Review⁵ can be found as indicated in the respective footnotes. An oral hearing was held before PTAB on July 16, 2014; PTAB's decision is expected prior to December 19, 2014. The trial in the Litigation is currently scheduled for March 2, 2015.

8.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 conditions, 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 statement of operations 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 because the Company's stock options are "plain vanilla," as defined by the U.S. Securities and Exchange Commission in Staff Accounting Bulletin No. 107, they are reflected only in equity and compensation expense accounts.

³ The Patent expires in October 2014 and, accordingly, the claims for prospective injunctive relief will be rendered moot at that time.

⁴ See: U.S. District Court for the Middle District of Florida, Case No. 5:12-cv-366, the public files for which are available at www.pacer.gov by referencing the Middle District of Florida and the specific Case No. 5:12 CV 366, although access is subject to government charges for such access.

⁵ See: the Patent Trial and Appeal Board of the U.S. Patent and Trademark Office, the public files for which are available at <https://ptabtrials.uspto.gov/> by entering "5527533" in the block for "Patent Number" and then clicking "Search."

Stock Options

As of June 30, 2014, the Company had the following two shareholder approved plans under which shares were available for equity based awards: The 2005 Stock Option Plan (the “2005 Plan”) wherein 2,075,000 shares of common stock are reserved for issuance until the Plan terminates on August 21, 2015, and; The Independent Director Stock Option and Stock Grant Plan (the “2004 Directors Plan”) wherein 200,000 shares of common stock are reserved for issuance until the plan terminates in 2014.

Under the 2005 Plan, eligible employees and certain independent consultants may be granted options to purchase shares of the Company’s common stock. The shares issuable under the 2005 Plan will either be shares of the Company’s authorized but previously unissued common stock or shares reacquired by the Company, including shares purchased on the open market. As of June 30, 2014, there were 424,068 options available for grant under the 2005 Plan.

Under the 2004 Directors Plan, upon election to the Board of Directors at an annual stockholders meeting, a newly elected non-employee director will be granted a ten-year option to purchase 6,000 shares of the Company’s common stock. Options vest and become exercisable six months from the date of grant. In addition, on the date of each annual stockholders meeting, each non-employee director continuing in office is automatically issued 4,000 shares of the Company’s common stock, and an additional 1,000 shares to the director serving as Chairman of the Board, non-transferable for six months following the date of grant. As of June 30, 2014, there were 121,123 shares available for grant under the 2004 Directors Plan.

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

	As of June 30, 2014		
	Authorized	Available	Outstanding
2005 Plan	2,075,000	424,068	1,456,166
2004 Directors Plan	200,000	121,123	12,000
Total	2,275,000	545,191	1,468,166

All stock option grants made under the 2005 Plan and the 2004 Directors Plan 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 2004 Directors Plan were determined by the Board of Directors or the Stock Option and Compensation Committee of the Board 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 \$192,000 and \$178,000 for the three months ended June 30, 2014 and 2013, respectively. There was no compensation expense recognized for options issued under the 2004 Directors Plan during the three months ended June 30, 2014 and 2013, respectively. All share-based compensation has been classified as general and administrative expense.

A summary of option activity under the Company's stock plans for the three months ended June 30, 2014 is presented below:

Option Activity	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (years)	Aggregate Intrinsic Value
Outstanding at March 31, 2014	1,469,306	\$ 4.04	7.3	\$2,034,303
Granted	—	—	—	—
Exercised	—	—	—	—
Forfeited or expired	(1,140)	\$ 3.36	—	1,748
Outstanding at June 30, 2014	1,468,166	\$ 4.04	7.1	\$1,169,785
Exercisable at June 30, 2014	617,100	\$ 3.47	6.6	\$738,973

The aggregate intrinsic value as of June 30, 2014 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 \$4.50 for such day.

A summary of the Company's non-vested options for the three months ended June 30, 2014 is presented below:

Nonvested Options	Shares	Weighted Average Grant-Date Fair Value
Nonvested at March 31, 2014	851,066	\$ 3.22
Granted	—	—
Vested	—	—
Forfeited or expired	—	—
Nonvested at June 30, 2014	851,066	\$ 3.22

The following table summarizes the weighted average characteristics of outstanding stock options as of June 30, 2014:

Range of Exercise Prices	Outstanding Options			Exercisable Options	
	Number of Shares	Remaining Life (Years)	Weighted Average Price	Number of Shares	Weighted Average Price
\$ 1.60 - \$3.70	428,230	6.2	\$ 2.93	387,910	\$ 2.86
\$ 3.71 - \$4.42	728,936	7.2	3.82	149,940	3.82
\$ 4.43 - \$5.40	72,500	7.7	5.17	27,500	5.18
\$ 5.41 - \$7.08	238,500	8.1	6.38	51,750	6.16
Total stock options	1,468,166	7.1	\$ 4.04	617,100	\$ 3.47

There were no stock options granted during the three months ended June 30, 2014 and June 30, 2013, respectively. The value assumptions related to options granted during the fiscal year ended March 31, 2014 were as follows:

	2014
Exercise Price:	\$5.56
Volatility:	38.00%
Risk Free Rate:	0.14%
Vesting Period (months):	6
Forfeiture Rate:	0.00%
Expected Life (years):	1.00
Dividend Rate:	0%

As of June 30, 2014, total unrecognized share-based compensation expense related to all unvested stock options was \$1,824,000 which is expected to be expensed over a weighted average period of 3.4 years.

9. INCOME TAXES

We utilize our estimated annual effective tax rate to determine our provision (benefit) for income taxes for interim periods. The income tax provision (benefit) is computed by taking the estimated annual effective tax rate and multiplying it by the year to date pre-tax book income (loss). We recorded income tax benefit of \$751,000 and an income tax expense of \$106,000 for the three months ended June 30, 2014 and 2013, respectively. Our effective tax rate was 64.5% and 77.9% for the quarters ended June 30, 2014 and June 30, 2013, respectively. The effective tax rate for the three months ended June 30, 2014 differs from the statutory rate of 34% as a result of the state taxes (net of federal benefit) and permanent differences.

The Company is subject to taxation in the United States and two state jurisdictions. The preparation of tax returns requires management to interpret the applicable tax laws and regulations in effect in such jurisdictions, which could affect the amount of tax paid by the Company. Management, in consultation with its tax advisors, files its tax returns based on interpretations that are believed to be reasonable under the circumstances. The income tax returns, however, are subject to routine reviews by the various taxing authorities. As part of these reviews, a taxing authority may disagree with respect to the tax positions taken by management (“uncertain tax positions”) and therefore may require the Company to pay additional taxes. Management evaluates the requirement for additional tax accruals, including interest and penalties, which the Company could incur as a result of the ultimate resolution of its uncertain tax positions. Management reviews and updates the accrual for uncertain tax positions as more definitive information becomes available from taxing authorities, completion of tax audits, expiration of statute of limitations, or upon occurrence of other events.

As of June 30, 2014, there was no 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 income or expense in its consolidated condensed statements of operations, which is consistent with the recognition of these items in prior reporting periods.

With few exceptions, the Company is no longer subject to U.S. federal, state, local, and non-U.S. income tax examination by tax authorities for tax years before 2009.

10. EARNINGS (LOSS) PER SHARE

Basic earnings (loss) per share is computed on the basis of the weighted average number of common shares outstanding. Diluted earnings (loss) 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 using the “treasury stock” method.

Reconciliations between the numerator and the denominator of the basic and diluted earnings (loss) per share computations for the three months ended June 30, 2014 and 2013 are as follows:

	Three Months Ended June 30, 2014	
	Net Loss	Shares
	(Numerator)	(Denominator)
	(in thousands)	
Basic loss per share	\$ (413)	5,488
Effect of dilutive securities—Common stock options—	—	—
Diluted loss per share	\$ (413)	5,488
		Per Share Amount
		\$ (0.08)
		—
		\$ (0.08)

	Three Months Ended June 30, 2013	
	Net Income	Shares
	(Numerator)	(Denominator)
	(in thousands)	
Basic income per share	\$ 30	5,464
Effect of dilutive securities — Common stock options—	—	151
Diluted income per share	\$ 30	5,615
		Per Share Amount
		\$ 0.01
		—
		\$ 0.01

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 (loss) per share does not include the impact of common stock options totaling 657,642 and 712,252 for the three months ended June 30, 2014 and 2013, respectively, as the effect of their inclusion would be anti-dilutive.

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

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;

The 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 the current local, national and world economic crises, 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;

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 involved in any litigation, and the direct and indirect cost and other effects on our business or financial condition resulting from any litigation decision adverse to the Company;

The 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.

Overview:

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, co-workers and the communities we live in), and quality of the environment in which we work. Our products include:

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; and

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

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 provide 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, free of pesticides and herbicides. 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.

Results of Operations

The following tables present selected consolidated financial data for each of the periods indicated (\$ in thousands):

	Three Months Ended	
	June 30, 2014	June 30, 2013
Net sales	\$7,442	\$6,909
Net sales increase	7.7	%